OVERSIGHT OF GOVERNMENT MERGER ENFORCEMENT POLICY

HEARING

BEFORE THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

OVERSIGHT OF GOVERNMENT MERGER ENFORCEMENT POLICY

JULY 21, 1982

Serial No. J-97-76

Part 2

Printed for the use of the Committee on the Judiciary

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON :

S521-8

COMMITTEE ON THE JUDICIARY

STROM THURMOND, South Carolina, *Chairman*

CHARLES McC. MATHIAS, Jr., Maryland	JOSEPH R. BIDEN, Jr., Delaware
PAUL LAXALT, Nevada	EDWARD M. KENNEDY, Massachusetts
ORRIN G. HATCH, Utah	ROBERT C. BYRD, West Virginia
ROBERT DOLE, Kansas	HOWARD M. METZENBAUM, Ohio
ALAN K. SIMPSON, Wyoming	DENNIS DeCONCINI, Arizona
JOHN P. EAST, North Carolina	PATRICK J. LEAHY, Vermont
CHARLES E. GRASSLEY, Iowa	MAX BAUCUS, Montana
JEREMIAH DENTON, Alabama	HOWELL HEFLIN, Alabama
ARLEN SPECTER, Pennsylvania	

VINTON DeVANE, LIDE, *Chief Counsel and Staff Director*
MARK H. GITENSTEIN, *Minority Chief Counsel*
W. STEPHEN CANNON, *Chief Antitrust Counsel*

CONTENTS

STATEMENTS OF COMMITTEE MEMBERS

	Page
Thurmond, Chairman Strom	1
Metzenbaum, Howard M	8

CHRONOLOGICAL LIST OF WITNESSES

Miller, Hon. James C., III, Chairman, and Hon. David A. Clanton, Commissioner, Federal Trade Commission, Washington, D.C	2
Baxter, Hon. William F., Assistant Attorney General, Antitrust Division, U.S. Department of Justice	33

ALPHABETICAL LISTING AND MATERIALS SUBMITTED

Baxter, Hon. William F.:	
Testimony	33
Response to questions submitted by Committee members	49
Clanton, David A.:	
Testimony	5
Prepared statement	21
Miller, James C., III:	
Testimony	2
Letter from Sen. Metzenbaum with response, concerning deliberate actions by the oil industry triggering sharp rises in retail gasoline prices	13
Prepared statement	21
Response to Sen. Specter's question about oil company mergers	32
Separate statement of Commissioner Pertschuk	33

OVERSIGHT OF GOVERNMENT MERGER ENFORCEMENT POLICY

WEDNESDAY, JULY 21, 1982

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The committee met, pursuant to notice, at 10:12 a.m., in room 2228, Dirksen Senate Office Building, Hon. Strom Thurmond (chairman of the committee) presiding.

Also present: Senators Metzenbaum and Specter.

Staff present: Marcy J. K. Tiffany, chief economist and antitrust counsel; Stephen Cannon, chief antitrust counsel; Peter Chumbris, senior antitrust counsel; Mary Louise Westmoreland, counsel; Wes Howard, counsel; Marge Baker, counsel; Ally Milder, counsel; Arthur Briskman, counsel.

OPENING STATEMENT OF SENATOR STROM THURMOND

The CHAIRMAN. The committee will come to order.

In 1968 the Department of Justice issued guidelines for determining whether to oppose corporate mergers under section 7 of the Clayton Act. Since that date there have been significant developments in both the legal and economic analysis of mergers. Although changes in the enforcement policy of the Department have occurred over time to incorporate these developments, the guidelines have remained unchanged.

On June 14, 1982, the Department of Justice issued a new set of merger guidelines. These guidelines are intended to accurately reflect the present policy of the Department concerning mergers.

On the same day, the Federal Trade Commission issued its first statement of policy concerning horizontal mergers. Since the Federal Trade Commission shares review authority over mergers with the Department of Justice, this statement of policy is an important complement to the Justice Department guidelines.

It is thus fitting for the committee to consider both the Department of Justice guidelines and the Federal Trade Commission statement at this oversight hearing. Today, the committee will receive testimony from representatives of the Federal Trade Commission and the Department of Justice. At a later date, the committee will offer an opportunity to members of the professional and business communities to express their views regarding the administration's merger policy.

Our first panel consists of James C. Miller, Chairman, and David A. Clanton, Commissioner of the Federal Trade Commission.

Gentlemen, we are glad to have you with us today and you may proceed to testify.

STATEMENT OF A PANEL CONSISTING OF HON. JAMES C. MILLER III, CHAIRMAN, AND HON. DAVID A. CLANTON, COMMISSIONER, FEDERAL TRADE COMMISSION, WASHINGTON, D.C.

Chairman MILLER. Thank you, Mr. Chairman. I am pleased to have this opportunity to discuss the Federal Trade Commission's statement concerning horizontal mergers, which was released on June 14.

As you noted, joining me today in presenting the Commission's views is Commissioner David Clanton, who helped coordinate the drafting of the statement that we have provided and that you have cited.

Mr. Chairman, this statement marks the first time in its 68-year history that the Commission has spoken out officially on its general policy concerning horizontal mergers. Furthermore, the fact that this statement was approved unanimously by the Commission is important and reflects the commitment of the FTC to vigorous and efficient enforcement of the antitrust laws governing horizontal mergers.

This statement is the culmination of extensive work accomplished during the past year by teams of FTC attorneys and economists. The initial efforts were begun in March 1981 under the direction of then Acting Chairman Clanton. This initiative was prompted by the Commission's consensus that the guidelines issued by the Department of Justice in 1968 required revision to reflect the significant developments in merger law and economic analysis that had transpired over the ensuing 14 years.

Since the Department of Justice also contemplated issuing guidelines, the Commission initiated a liaison with the Department to facilitate cooperation on this matter. In particular, the Commission and the Antitrust Division formed working groups of lawyers and economists to evaluate past merger enforcement experience and to recommend specific modifications.

These groups exchanged views and discussed ways to address the issues. In addition, both agencies solicited and carefully examined the views of the private bar, the academic and business communities, as well as the public at large. We greatly appreciate the hard work and thoughtful insights of the many individuals who contributed to the formulation of ideas contained in the FTC's statement.

This process enabled the Commission to issue a set of enforcement principles which, while appropriately reflecting our different institutional organization, are in complete harmony in all important respects with the revised Justice Department guidelines.

The policy differences between the Justice guidelines and our statement are indeed minor. Whereas the Justice guidelines incorporate fairly specific numerical standards and other policy considerations, our statement places somewhat greater emphasis on the types of factors that will be considered at the Commission and the relative weight to be assigned to these factors in evaluating the competitive impact of a horizontal merger.

The Commission avoided proposing specific numerical criteria or other detailed analytical standards, believing that it would be unwise for the two agencies to publish fairly precise standards that might differ even in minor respects. To do so would only emphasize the differences and not the large areas of agreement, and would not promote the goals of certainty and fairness sought by enforcement agencies, businesses and the antitrust bar.

Accordingly, the Commission will accord considerable weight to the numerical standards in the Department of Justice guidelines in making the threshold determination of whether a horizontal merger warrants further antitrust scrutiny. What should be stressed is that the two documents reflect the same basic enforcement philosophy—namely, that Government enforcement authorities will examine carefully the likely effects of horizontal mergers in terms of probable harm to competition before taxpayer resources are committed to challenge such mergers.

Two other possible differences between the FTC statement and the Department of Justice guidelines might be noted. First, the Commission has determined that measurable operating efficiencies, such as production or plant economies of scale, can be considered as a policy matter in deciding whether to challenge a merger. Personally, I believe that scale-type efficiencies should also be considered as part of the postcomplaint legal analysis, but I am in a minority on the Commission on that.

Second, the FTC, in the exercise of its prosecutorial discretion, will consider evidence of a failing division and similar evidence that falls short of the technical requirements of the failing company defense. At the same time, the Commission will be stringent in evaluating whether a good-faith effort has been made to find the least anticompetitive purchaser. Again, personally I would go further, and would consider reliable evidence of a failing division to be raised as a legal defense in postcomplaint proceedings.

It should be pointed out, however, that even in these two instances any differences between the agencies are not that great, since the Justice guidelines do indicate acceptance of a failing company defense in appropriate cases and consideration of scale economies in extraordinary cases.

The Commission focused its work on horizontal mergers because of the greater competitive implications of this class of mergers. We continue, of course, to be interested in vertical and conglomerate acquisitions, especially potential competition mergers, but we believe that the Justice guidelines, coupled with the Commission's guidance expressed in past and pending adjudicative decisions, should prove an adequate indication of the agency's policy in these areas. If further guidance on these subjects should prove desirable in the future, the Commission will not hesitate to convey its views through a policy statement or other similar vehicle.

The Commission believes that issuance of the FTC's statement and Justice's guidelines will significantly improve understanding of the current merger enforcement policies of the Federal Government. Both agencies continue to emphasize the need for vigorous scrutiny of horizontal mergers and careful screening based on sound economic and legal analysis.

Mr. Chairman, that completes our prepared statement. Commissioner Clanton and I will be happy to address any questions you or your colleagues might have.

The CHAIRMAN. Mr. Clanton, did you have anything you wished to say?

Commissioner CLANTON. No; no separate statement, Mr. Chairman.

The CHAIRMAN. I have a few questions I would like to propound to you.

Dr. Miller, the Federal Trade Commission has never before issued a statement regarding its policy toward mergers. Why did the Commission suddenly decide to do so?

Chairman MILLER. Senator Thurmond, there has been a presumption in the past that the FTC was following the guidelines issued by the Department of Justice in 1968. In some cases that was true, but like the Department of Justice, as new economic analysis and new legal analysis developed over this interim period, the Commission too was moving away from the 1968 guidelines.

Second, I think it behooves the FTC—as a major participant in this antitrust enforcement effort of the Federal Government to police mergers that might reduce competition or tend to create a monopoly—to be involved in developing and articulating merger enforcement policy.

You see, Senator Thurmond, we actually review far more Hart-Scott-Rodino merger filings than does the Department of Justice. So, we are a key element in this effort, and we knew reasonably soon after Mr. Baxter took over that the Justice Department would be issuing guidelines. We knew, too, that immediate focus would be on the Commission as to what its reaction would be.

In March 1981, Commissioner Clanton indicated a strong need for the Federal Trade Commission to review merger developments and to draw up its own views—a formal statement of how it would go about enforcing the antitrust laws.

I think more information is better. It was inevitable, given that the Department of Justice was going to issue guidelines, that we would be asked for our views. To reduce uncertainty in the marketplace, and given that our views were very compatible with those of the Department of Justice, we decided to issue our own statement, which, as I have noted and I think a fair reading would give, is very compatible with and supportive of the guidelines issued by the Department of Justice.

The CHAIRMAN. Dr. Miller, the Department of Justice guidelines adopt the Herfindahl-Hirschman Index as a measure of concentration in lieu of the four-firm concentration ratio relied on in the 1968 guidelines. The Federal Trade Commission statement does not indicate what standard it will apply.

Does the Federal Trade Commission intend to apply the Herfindahl-Hirschman Index, and if so will their thresholds for investigation be the same?

Chairman MILLER. Yes, sir. I think, as our statement indicates, we will give considerable weight to the guidelines that were developed by the Department of Justice. And I want to personally applaud the Department for adopting the Herfindahl Index, a more sophisticated measure than simple four-firm concentration indices.

I think the research that has gone on over the 14 years since the issuance of the 1968 guidelines clearly indicates that one of the problems in looking at a simple four-firm concentration index is it does not take into account either the number of firms or, particularly, the size distribution of firms, and the Herfindahl Index does have that characteristic. Within broad ranges, it is possible to make an approximate correlation between the Herfindahl Index and a four-firm concentration ratio.

So, they are not dramatically different, but the Herfindahl Index is a bit more sophisticated representation of the important aspects of market structure that we should look at in making decisions about challenging mergers.

But the specific answer is that we will look very carefully at the 1,000 and 1,800 thresholds that were decided upon by the Department of Justice in the issuance of its guidelines.

The CHAIRMAN. The Department of Justice guidelines delineate the factors which it will consider in arriving at a market definition. The Federal Trade Commission statement is essentially quiet on this point. Does the FTC intend to follow the Department of Justice in its approach to defining the market?

Chairman MILLER. I think, Senator, a reading of our statement would indicate close compatibility between the characteristics of market that the Justice Department would take into account in defining a product market or a geographic market and those characteristics that we would take into account.

Let me ask Commissioner Clanton if he would care to add anything to that.

Commissioner CLANTON. I would just make one additional observation. The principal difference is the Justice Department's reference to a benchmark test for determining the ability of other suppliers outside the market to ship in or shift output into the market in question. They use a test that measures the degree to which product shifts will occur if there is a 5-percent increase in price in the market over various time frames.

As the Justice Department indicates, that test is a very useful effort. They use the term "first approximation" in characterizing the use of the test to determine if there is likely to be a shift in output between different regions with a slight increase in price. They also realize that that may not be the absolute answer in all cases, and you have to look at a variety of other factors, including shipment patterns and the like.

We would do the same thing. That is indicated in our statement. In that respect, the basic approach of the Department of Justice and the Federal Trade Commission is the same. I would add that we have just had a case recently since the guidelines were issued, which gave us an opportunity to look at both the FTC statement but also the Justice guidelines. We had staff make sure that they incorporated the kind of analysis that was in the Justice guidelines as well as the more general principles of the Commission's statement.

Indeed, even prior to the issuance of the guidelines, staff has been regularly calculating the Herfindahl Index in cases that come up to the Commission for review, along with the more traditional, conventional concentration numbers. I think there is no question

that that will continue, and indeed the Herfindahl will be the primary measure that we will be looking at down the road.

At the same time, in this recent acquisition we looked at characteristics of the market with respect to the ability of suppliers to shift supply in light of the criteria set forth in the Justice guidelines.

So, we certainly intend on a regular basis to look at the kinds of specific numerical considerations that are set forth in the Justice guidelines.

The CHAIRMAN. To the extent that the FTC and the Department of Justice differ in their approaches to evaluating mergers, will there not be continuing uncertainty in the business community about what mergers are likely to be challenged?

Chairman MILLER. No, Senator Thurmond, I do not think that is the case. In fact, that is the major reason for our issuing our statement. When the agency is completely quiet on the matter, I do not think people in the business community have a very good idea of what we are likely to do.

Especially since the collective wisdom of the Federal Trade Commissioners is very consistent with and supportive of the initiative taken by the Department of Justice, I think our issuing our policy statement will reduce uncertainty in the community that might be considering mergers.

Another thing, Senator Thurmond, to recognize is that, by convention, certain industries tend to go to the Department of Justice for consideration of proposed mergers; other industries tend to go to the Federal Trade Commission. By the Federal Trade Commission being silent, I think it is not only a question of which agency would get the merger, but it is what standards would the agency that is silent be planning to adopt. So, we spoke on that.

The CHAIRMAN. Chairman Miller, the FTC statement indicates that you disagree with the rest of the Commissioners with respect to the consideration of scale-type efficiencies. Would you explain the basis of your disagreement?

Chairman MILLER. I think it is very important, Senator, that we not stand in the way of mergers that eventually are going to lead to lower prices to consumers and to a better utilization of the Nation's resources.

Now, I know this is a controversial area and not all legal scholars would agree on this point. But I do feel that not only as a matter of prosecutorial discretion but also as a matter of judging whether a company is in violation of the law, I think it important to consider the efficiencies that might result from such a merger and what this would do in terms of ultimate prices to consumers. I consider this as part of our understanding of the competitive impact of a proposed merger, of whether it would tend to create a monopoly.

Now, let me hasten to add, of course, that we should not just accept any kind of evidence or any kind of argument as being sufficient reason to believe that there would be substantial economies generated from such a merger. I think we have to look at that information very carefully, but if the information were compelling, I would give that argument some weight in determining whether a law violation had occurred.

The CHAIRMAN. Dr. Miller, you also disagreed with the policy of the Commission not permitting evidence of a failing division as a legal defense in a merger proceeding. Would you comment on your reasons for this disagreement?

Chairman MILLER. Certainly. As before, let me emphasize that the difference between me and my fellow Commissioners is that I would not only, as would the other Commissioners, consider these as reasons not to bring a case, but once a case has been brought and argued before the Commission, I would consider this factor—the failing division defense—as a consideration in determining whether to find a law violation.

Again, the reason is I think it is important for the Nation's resources to be used productively. If a division is failing and if the result is that the company is going to spin off that division, then it is going to mean that those resources would not be in the market. It would mean that those resources would not lead to lower prices to consumers, but quite the reverse. Here, again, I think we should not accept wholly speculative evidence on this point, but should insist on very hard, concrete evidence.

But if I were convinced that the result would be that the resources in this division would be spun off and not used in this industry, I would tend to accept this as a defense with respect to the question of a law violation, just as the failing firm defense is accepted by the courts today.

The CHAIRMAN. Dr. Miller, how much cooperation was there between the FTC and the Department of Justice in the development of their respective guidelines?

Chairman MILLER. Senator Thurmond, let me start off by praising our colleague, General Baxter, at the Department of Justice. In measures involving the Federal Trade Commission, he has been most cooperative and forthcoming, and I hope that we have reciprocated.

I think that the relationship between the Federal Trade Commission and the Department of Justice overall is quite good and quite a healthy one. In terms of this specific initiative, let me ask Commissioner Clanton to discuss the initial efforts of cooperation between the Department of Justice and the Federal Trade Commission, since I was not at the Commission at that time and he was in charge of those matters.

The CHAIRMAN. Mr. Clanton.

Commissioner CLANTON. Mr. Chairman, we started to look at this whole issue, actually, shortly after the Justice Department announced early in 1981 that they were undertaking an effort to review the 1968 merger guidelines. The Commission at that time agreed that it would be desirable for us to undertake a very parallel effort, especially with respect to horizontal acquisitions, and we did that. We have been involved in that process for the year preceding the issuance of the new guidelines and Commission's statement.

I would also note that there were staff contacts and discussions between the two agencies on a fairly regular basis. We had a pretty good idea at the Commission of the general direction and focus of what the Justice Department was doing and the basic philosophy that was underpinning their changes to the merger guidelines.

So, I think that in terms of putting together the Commission's statement, we were in a position to attempt to write something that was as complementary and compatible as possible, which I think we did, recognizing, of course, that it would not have been desirable to have had two different sets of numerical guidelines for the reason the chairman indicated in his statement. For that reason, we specifically did not attempt to do that.

But we did have a good idea, and there were consistent, ongoing discussions, as I said, at a staff level, of the general directions that the Department was moving in.

The CHAIRMAN. Senator Metzenbaum.

Senator METZENBAUM. Thank you, Mr. Chairman. Mr. Chairman, I have an opening statement which I ask unanimous consent be inserted in the record.

The CHAIRMAN. Without objection, that will be done.

[The prepared statement of Senator Metzenbaum follows:]

PREPARED STATEMENT OF SENATOR HOWARD M. METZENBAUM

Mr. Chairman, I am pleased that we have this opportunity to ask some questions of our antitrust enforcement officials on the subject of mergers and the Government's enforcement policies. Merger's are an increasingly common phenomenon in our society. Sometimes, they provide a useful mix of services and business skills under one corporate roof, to the betterment of our Nation and our free enterprise system. However, all too often, mergers are simply a tool for big firms to get bigger, and the consumers pay the price for this excess size.

Congress has long been concerned with the anticompetitive, political and social evils associated with mergers, ever since it passed the Clayton Act in 1914. This concern has been repeatedly voiced, as we strengthened the antimerger laws in 1950 and again in 1976 by passage of the Hart-Scortt-Rodino Premerger Reporting Act. The debates surrounding these laws conclusively show that we have been wary of mergers not only where they may injure competition, but also where they lead to undue concentrations of power in a few corporate hands. We most recently witnessed this expression of concern over concentration last year when we watched the Mobil Oil Company attempt to gobble up one of its competitors, Marathon Oil Company. As we predicted, once the oil conpanies start merging, they are hard to stop: This year's case-in-point is Gulf Oil's attempt to purchase Cities Services.

Mr. Chairman, when do these mergers stop and where do we draw the line? Where do our antitrust laws discuss "efficiencies?" When did the Supreme Court say that Congress intended theoretical efficiencies as a defense to an otherwise harmful merger?

Now, however, we have heard our most senior antitrust enforcement officials tell us that mergers are usually good for us. They tell us that we should not fear bigness, and that mergers create this elusive concert of "efficiences". In accordance with these predilections for bigger and bigger concentrations of wealth and power, the Justice Department and the Federal Trade Commission have published "guidelines" and a "policy statement" which purport to reveal just when mergers are good and when they are not. Where the Supreme Court has interpreted the will of Congress but has not been in sympathy with these officials' pet economic theories, the Court's decisions have been ignored. As I have said before, I do not believe that it is the role of appointed officials to pick and choose among Supreme Court decisions for statements that they like. I am hopeful that these guidelines and policy statement will assist us to focus on exactly what our antitrust enforcement officials intend to do when carrying our their solemn duties to uphold the law as Congress and the President have expressed it. As I have looked over the guidelines, however, I have found much lofty economic discussion, but little practical help for those who must predict the legality of business behavior. The antitrust laws were not and are not now intended to express an economic theory. They exist to protect our free enterprise system from the evils of corporate excess. I am worried that these guidelines were intended not to explain the antimerger laws so much as to explain a particular theoretical model of which their authors are so fond.

Mr. Chairman, I am especially concerned that today's new wave of mergers are depleting our scarce supply of capital and impeding the innovation and courageous

expansion of ideas that spring from independent firms that must fight to compete. The recent spate of oil company mergers add not one drop of oil to our reserves, produce no new methods of production, and make it no more efficient to sell gasoline at the pumps. Congress has said again and again that such corporate unions must be stopped. I hope this hearing will reveal that our enforcement officials intend to perform their proper function and put a halt to mergers that do our Nation no good.

Senator METZENBAUM. Mr. Miller, the recent Gulf-Cities Service merger attempt appears to be the first test of the new guidelines, and I would like to get from you some appraisal as to how the theories embodied in these guidelines will work—it is one thing to have the words; it is another thing to apply the words to the facts.

The guidelines discuss many different factors for defining markets. For example, one common theme is the prediction of what would happen in a market if prices went up 5 percent for some given period.

In the context of oil company mergers, how do you expect to predict, in the limited time available under the premerger reporting requirements, what people would do if prices went up a hypothetical 5 percent per year? Is it not a totally unrealistic method for analyzing the effects of mergers?

While you are answering that, why do you not try to be good enough to tell me why you are not willing to investigate, as I asked you to do, the conduct of the oil companies in pushing up prices so that it affected the Consumer Price Index and was the major factor in affecting it?

You are part of an administration that is committed to holding down the spiral of inflation. The oil component itself added to the fact that inflation went up at the rate of 12 percent last month. You responded, at least; Mr. Baxter has been too busy to respond. I am just wondering what the hell you are doing and why you are not doing something about what is happening in this country.

That is a simple question. How are the guidelines going to help us?

Chairman MILLER. Well, I think the guidelines will help us, and the principles we have enunciated in our statement will help us because they tell you, I think, sir, and they tell other people in public office and they tell people in the private sector the kinds of indices that we will look at and how we think about those indices and what sort of framework we have in determining whether a merger would violate the law.

Because we do not have all the evidence we need in this matter, as you probably know—on Gulf-Cities Service, Senator, we issued second requests for additional information, and the only reason I can verify that is, of course, that the companies have publicly confirmed that the second request were issued.

But you realize that under Hart-Scott-Rodino processes, we cannot talk about the specific facts of that case. I will just assure you, Senator, that we are looking at this matter very, very carefully. We have a great deal of information. Our staff is pouring over this information with a fine-tooth comb. We are looking at it very carefully and it will be coming to the Commission for determination.

I realize that this might not be a sufficient answer for you, but within the context of the law I really cannot tell you very much more about it.

Now, in responding to your request that we investigate the petroleum antitrust industry, first of all it is usually the case that petroleum issues do reside at the Federal Trade Commission rather than at the Department of Justice. So, I had the staff look into this matter, as we take any inquiry from Congress very seriously. I met with them on at least two occasions. They put together some information for my review.

On the basis of what they concluded and my own assessment, it would seem to me that at the present moment there is not enough there for us to justify launching a formal investigation of petroleum companies' activities.

You pointed out that petroleum prices gave rise to an increase in the Consumer Price Index. Over some months, those prices contributed to a fall or reduction in the Consumer Price Index. That is an industry that is responding to market forces, and at least the characteristics of that response tend to reflect competitive conditions.

But if we become convinced, Senator, that that is not the case, I assure you that we will launch a full-scale investigation into that matter.

Senator METZENBAUM. But let us look at the facts. There is a world glut of oil. Now, when you have more supply than demand, prices normally come down. The reality is that the world prices of oil have come down. There is plenty of oil in this country; we are importing less, not more.

The oil companies have unquestionably closed down their refineries. If you close down the refineries, you are going to have a lesser supply in spite of the fact that the basic supply is there. You are going to have a lesser supply of refined product, although the basic supply is there.

They have closed down their refineries for that which would appear to be the obvious reason of cutting back the supply that is available. Now, that would at the very least suggest an attempt to cut back on supply so that we have a shortage of supply and prices would rise.

Now, under those circumstances, you are the one agency in Government that is left that is supposed to have a consumer concern, and I use the words "supposed to have" deliberately, because I did not say to you in my communication that there definitely was a conspiracy to hold back because I have no knowledge of that. But you are the agency that has the ability to investigate the matter.

What you are saying is you discussed it with economists, I think, and Commission attorneys instead of making any inquiry as to what the actual facts are—why they closed them down, why prices have gone up—there has been no increase in cost; there has been a decrease in cost. You know, there was an old TV program that used to refer to the facts—just the facts. Yet, prices have gone up to the American people and have had a tremendous impact upon the entire economic picture.

The FTC, which has the authority and the ability to do something about it, failed to act. Now, I just say to you who else can the American people turn to if not to the FTC in a matter of this kind?

Chairman MILLER. Well, Senator, I would just reiterate that we did take very seriously your inquiry and your suggestion that there might be a conspiracy here. Of course, those very economists and attorneys to whom I turned were those who had gone through a very extensive investigation of the oil companies in the past several years, culminating in a decision by the Commission to close the litigation relating to that investigation.

Now, they are quite expert on what is going on in this industry, and they took very seriously the question that you raised and they did look at a great many facts. They did not take this lightly, sir. On the basis of their review of the facts and the evidence, they came back to me with a recommendation that we not launch a full-scale investigation at this time because their reading of the facts was that there was not sufficient reason for us to believe that there was a conspiracy to commit taxpayers' funds to this matter.

We have to administer the FTC efficiently and use our funds in effective ways. While there might possibly be a conspiracy there—I cannot say that for a fact—looking at the evidence and evaluating the evidence, the conclusion they drew was that there was not sufficient cause for concern to launch a fullscale investigation of this industry.

Senator METZENBAUM. Mr. Miller, did they tell you that crude oil prices are rising?

Chairman MILLER. Yes, sir, but, Senator Metzenbaum, I would be happy to place——

Senator METZENBAUM. Wait a minute.

Chairman MILLER. Excuse me.

Senator METZENBAUM. If they told you that crude oil prices were rising, they lied to you, because you do not have to be a genius to read the Lundberg letter or to read anything else in this context.

Chairman MILLER. Excuse me; I misspoke. You said crude oil prices; I thought you were talking about pump prices. Crude oil prices have fallen. In fact, they are very volatile, as you know.

Senator METZENBAUM. OK, you are right; they are falling. But you wrote in your letter, "When crude oil prices are also rising, as has been true since the OPEC meeting in May, an escalation in product prices would be expected to follow."

Now, what I am saying to you is that you did not need to go to your economists or your attorneys; you only had to read the Lundberg letter, the New York Times, the Wall Street Journal.

As you and I both agree, sitting here—and you say that you did misstate it—crude oil prices have been not rising, but they have been falling. Therefore, the whole premise of your response is erroneous, and I suggest you go back and take another look and find out, when crude oil prices are falling, why the price to the public is rising.

That is the whole thrust of my inquiry, and your whole response is based upon the fact that they are rising, which is just a total falsehood. I mean, I am not blaming you for a falsehood, but what I am saying is it just is not true.

Chairman MILLER. Senator Metzenbaum, as you just admitted, crude oil prices are very volatile. They go up sometimes; they go down sometimes. There is a long lag, depending on what kind of

process you use, between crude and processed gasoline of various varieties. There are also spot prices; there are long-term contracts.

It is a more complicated issue than simply looking at some index of crude prices. I will be glad to go back and demand support for the statement I have in my letter. I would be glad to make my letter to you, sir, a part of the record, if you would like. And I will go back and ask the question on this particular statement, and respond to you with specific facts to back it up, or if the information I receive is incorrect, then I will revisit the issue. I promise you that.

Senator METZENBAUM. I would appreciate it. And I would ask at this time, Mr. Chairman, that my letter to Mr. Miller as well as Mr. Miller's letter of response to me be included in the record.

The CHAIRMAN. Without objection, it is so ordered.

[The letters referred to follow:]

STROM THURMOND, S.C., CHAIRMAN
CHARLES McC. MATHIAS, JR., MD.
PAUL LAXALT, NEV.
ORRIN G. HATCH, UTAH
ROBERT DOLE, KANS.
ALAN K. SIMPSON, WYO.
JOHN EAST, N.C.
CHARLES E. GRASSLEY, IOWA
JEREMIAH DENTON, ALA.
ARLEN SPECTER, PA.
JOSEPH R. BIDEN, JR., DEL.
EDWARD M. KENNEDY, MASS.
ROBERT C. BYRD, W. VA.
HOWARD M. METZENBAUM, OHIO
DENNIS DeCONCINI, ARIZ.
PATRICK J. LEAHY, VT.
MAX BAUCUS, MONT.
HOWELL HEFLIN, ALA.
VINTON DeVANE LIDE, CHIEF COUNSEL
QUENTIN CROMMELIN, JR., STAFF DIRECTOR

United States Senate
COMMITTEE ON THE JUDICIARY
WASHINGTON, D.C. 20510

June 15, 1982

The Honorable James C. Miller, III
Chairman
Federal Trade Commission
Pennsylvania Avenue and 6th Street, N.W.
Washington, D.C. 20503

Dear Chairman Miller:

I am deeply concerned that deliberate actions by the oil industry may have triggered sharp rises in retail gasoline prices.

This hike has occurred during a period when world and domestic crude oil prices have been falling, supplies have been ample and consumer demand has been relatively steady.

Despite these facts, domestic refiners have been shutting down facilities, drawing down stocks by abnormally large amounts and paring back production.

The fact that the price rise has arrived at the start of the summer driving season, normally the peak period for gasoline consumption, raises serious questions as to whether there is a free and competitive market in this industry.

I am also concerned that the industry's practices may lead to gasoline shortages this summer as well as heating oil shortages this winter.

In light of these unusual developments -- sharp cuts in gasoline production during a time of ample supply and steady demand resulting in much higher prices -- I formally request the Federal Trade Commission to conduct a thorough and immediate investigation of the refinery industry to determine whether it has deliberately manipulated supply and prices.

Let me elaborate on the reasons why I believe such an investigation is both timely and urgent.

During the past year, the international oil market has been operating with a supply surplus. In March, the Petroleum Industry Research Foundation estimated that the world-wide surplus stood at one million barrels a day.

This surplus has contributed to a decline in crude oil prices. According to the Department of Energy, the contract price for crude oil in the international market has dropped by more than $2 a barrel over the last eight months. At

11-281 O—82——3

the same time, the spot market price in Rotterdam has fallen as much as $7 a barrel.

Similarly, the domestic supply of crude oil has far exceeded demand. As a result, contract prices have fallen at least $3 a barrel, according to DOE. And the spot price has plunged below $28 a barrel in some areas.

Yet, despite these abundant supplies and falling prices, domestic refiners have been shutting down refineries and cutting production at several facilities over the last 18 months. In fact, DOE figures show the domestic refinery capacity utilization rate has dropped from 82.1 percent in January to 64.7 percent in April, 1982. These figures, of course, do not reflect the additional refinery capacity that has been permanently closed down.

Specifically, refineries owned by the ten largest oil companies, which control more than 70 percent of the refinery market nationwide, have reduced their average intake for refinery production by 260,000 barrels a day during the past 12 months.

While refinery capacity and gasoline production have fallen, the industry has drawn down existing stocks of gasoline and other refined petroleum products. Consider that in January, total domestic gasoline stocks stood at 262 million barrels (down 12 million barrels from January, 1982) and today, stocks are down to 210 million barrels, a staggering 52 million plunge.

As a result of this draw down, stocks are now slightly below the National Petroleum Council's defined minimum operating level -- the minimum level required for routine operation; that is, operation without run-outs and shortages.

On the West Coast, stocks are 23 percent lower than a year ago; in the Indiana, Illinois and Western Ohio region, stocks are down 29 percent from last year. Finally, industry publications report that independent terminal operators, jobbers and marketers are claiming that refiners have begun to allocate gasoline supplies. Indeed, actual shortages of unleaded fuel have already occurred in some markets.

Artificial output restrictions in a concentrated industry are a classic sign of the exercise of market power. Bork, Antitrust Paradox, P. 185 (1978) It is certainly not necessary to show an express agreement among the oil companies to limit supplies in order to condemn this conduct under the antitrust laws. American Tobacco Co. V. U.S., 328 U.S. 781, 809-810 (1946); Interstate Circuit, Inc. V. U.S., 306 U.S. 208 (1939). If it is true that the refineries are taking advantage of their tight market structure to tacitly limit supplies and cause prices to rise, they have illegally tampered with price structure. United States V. Socony-Vacuum Oil Co., 310 U.S. 150 (1940).

In light of the facts outlined above, and in light of the legal precedents cited, I believe it is essential for your agency to conduct a thorough and comprehensive probe of the refinery industry.

Naturally, I recognize that it is difficult to determine beyond a reasonable doubt whether there is in fact illegal

price fixing within the industry. But that should not deter you from conducting an investigation. The stakes are too high for American consumers to have this matter sloughed off.

I look forward to a prompt reply to this request. Thank you for your time.

Very sincerely yours,

Howard M. Metzenbaum
United States Senator

FEDERAL TRADE COMMISSION
WASHINGTON, D. C. 20580

OFFICE OF
THE CHAIRMAN

July 8, 1982

The Honorable Howard M. Metzenbaum
United States Senate
Washington, D.C. 20510

Dear Senator Metzenbaum:

Thank you for your letter of June 15, 1982, in which you request a Federal Trade Commission investigation of recent price and supply practices of the refining industry. You noted in your letter, and in our subsequent telephone conversation, that gasoline prices have been rising, stocks have been depleting, and refining utilization has been declining, despite abundant supplies of crude oil and relatively steady consumer demand.

I share your concern about rising gasoline prices and possible reductions in supply. The Commission maintains a strong commitment to competition in the petroleum industry and will carefully monitor the refining situation. However, based on my discussion of the concerns expressed in your letter with the Commission's attorneys and economists who have experience in dealing with petroleum industry matters, it seems entirely plausible that the behavior observed is consistent with competition rather than an attempt to monopolize. Let me turn now to a possible explanation of recent behavior in the petroleum refining industry.

The phenomena you describe may well be the result, not of anticompetitive conduct, but rather of individual firms' competitive responses to changing conditions in the refining industry. As a result of the rapid increase in crude oil prices in the late 1970's and the recent economic slow down, the present demand for petroleum products has been substantially below what might have been predicted just a few short years ago. This has apparently resulted in the overcapacity in the domestic refining

industry noted in your letter, and, until very recently, the "softness" of product prices. Because of these conditions, individual refiners may have reacted by reducing refinery utilization and by selling off excess inventories, and it appears that they may indeed have overreacted. In the short run, this would cause product prices to rise, even in the face of stable crude oil prices and steady demand for gasoline.

When crude oil prices are also rising, as has been true since the OPEC meeting in May, an escalation in product prices would be expected to follow. Wholesalers, believing that product prices will be even higher in the future, will attempt to increase their inventories, leading both to a short-run increase in demand and a depletion in primary refinery inventories, as secondary wholesaler inventories increase. The same market mechanisms that lead to price increases in the short run, therefore, may lead to increased output of petroleum product as refiners react to the new market conditions. This would be expected to result in lower or more stable prices. Recent news reports indicate that refinery utilization rates are higher than they have been in more than a year, causing recent price quotations to fall.

Thus, based on available information, a formal investigation of this matter does not appear warranted at present. As you know, our attorneys and economists are currently conducting a number of important petroleum inquiries. Also, as I stated earlier, they will continue to monitor conditions in the refining industry, and should any evidence of antitrust violations come to our attention, we would, of course, undertake a formal investigation at that time.

Senator Metzenbaum, thank you again for your letter and phone call, bringing this matter to our attention. If there are any questions about the points raised in this letter, please feel free to have your staff contact Ronald B. Rowe (724-1441), the Assistant Director of the Bureau of Competition who has responsibility for petroleum matters, or Dr. James M. Ferguson, (632-4920), Assistant Director of the Bureau of Economics, who has responsibility for antitrust matters.

Sincerely yours,

James C. Miller III
Chairman

The CHAIRMAN. Senator, I have got to go to the Supreme Court. I ought to be back in about 30 minutes, so would you kindly preside?

Senator METZENBAUM. Yes, I can preside until 11:30.

The CHAIRMAN. When Dr. Miller finishes, then Mr. Baxter, I believe, is the next witness, and we will ask counsel to propound questions to him, if I am not back by then, as representing me.

Senator METZENBAUM. If the chair would not mind, when we get to Mr. Baxter, since you will not be here, I would like to ask Mr.——

The CHAIRMAN. I may get back.

Senator METZENBAUM. Yes. If you do not, I will go forward with my questions to him and then turn it over to counsel with respect to your questions, and have the record reversed.

The CHAIRMAN. I do not think it makes any difference.

Senator METZENBAUM. I am sure it does not.

[Whereupon, Senator Metzenbaum assumed the chair.]

Senator METZENBAUM. Let us come back to the guidelines. How does anybody determine what to do or how to act in connection with the Gulf-Cities Service merger or any other merger? How does a lawyer find enough specifics in connection with these guidelines to be able to advise a client that this merger will or will not fly? That concerns me. They are very illusory, they are very difficult to pin down, they are very generalized.

Normally, when you get through reading guidelines, you ought to know what the answers are.

Chairman MILLER. Senator Metzenbaum, there is, of course, a tradeoff here between specificity in terms of numbers and being able to view a merger that is proposed and bring to bear all of the ramifications or all of the aspects that would bear on a decision of whether, under the law, it is a merger that would substantially lessen competition or tend to create a monopoly.

Now, the basic idea of guidelines is to give people out in the private sector—and also to give guidance to the staff—enough information to give some prediction as to where the agency would come out, and in the case of the Antitrust Division, whether they would prosecute; in the case of the Federal Trade Commission, whether they would bring a complaint or seek a preliminary injunction, but also some indication of how they would decide the case as judges.

Now, because Federal Trade Commissioners are also judges, it would be expected that we would be a little less specific than we would if we were only prosecutors. But I think that on this tradeoff of giving enough specificity but yet not going so far as to tie our hands so that we could not make very informed decisions as judges, I think we have done the right thing.

We have indicated, I think, fairly clearly how we would go about deciding merger cases and the body of analysis and analytical framework we would use.

Senator METZENBAUM. As part of the market definition process, the guidelines ask which companies could and would shift resources to begin production of a different product if prices in the challenged industry went up 5 percent for 6 months. Now, how can that theoretical prediction be made in the real world in which we live?

Chairman MILLER. Well, Senator, defining the market is not an easy task, but everyone agrees that it is more than simply the people selling at an instant in time. So, the question is what additional firms or sales to include in the market.

General Baxter has outlined a way of conceptualizing what should be included: if you had a 5-percent increase in price, whether there would be a substantial increase in the flow of supplies. While there is probably nothing magic in those numbers, I think it is an appropriate way to address the issue.

There are other ways as well. An economist would say, do we have any ideas about the cross-elasticities of supply for two products, and if they were very high, then we would include both of those in the same market. There are other ways of looking at the issue and perhaps other types of evidence that might be brought to bear on the matter.

But when you define a market, you invariably are going to have to make some tough decisions, and to consider evidence on what effect a 5-percent price increase would have is hardly substantially more of a problem than to determine the parameters of a market as conventionally defined.

Senator METZENBAUM. The FTC has historically been active in challenging vertical mergers that hurt our economy. What can we expect of the FTC now with respect to vertical mergers and the harmful effect of new acquisitions on a vertical basis?

Chairman MILLER. We will enforce the law. Where we conclude that a vertical merger would foreclose competition, would be adverse to the public interest, and would violate the relevant portions of the antitrust laws, we would take issue with it.

Commissioner Clanton might want to amplify.

Commissioner CLANTON. I think in that area, both agencies over the last 5 or 6 years have recognized that the issues are more complex than the earlier cases seemed to recognize. There are some real tradeoffs involved in terms of the potential for increased market power on the one hand and the ability for increased benefits or efficiencies to flow from a vertical merger. You are not immediately talking about increases in concentration as such, but rather the potential of a vertical acquisition either, on the one hand, to increase entry barriers into both of those vertical markets, or as a result of the vertical integration, to increase the potential for collusion among the remaining firms in the market of the aquiring company.

We frankly do not have as good empirical or economic bases for trying to anticipate what the competitive harms in those areas are as much as we do in the horizontal market, to be quite candid. There is just nowhere near the kind of economic consensus in that area.

As a result of that—and I think it is reflected in the enforcement experience of the agencies for some period of time even prior to the issuance of these guidelines—we want to be fairly sure that the effect of a vertical merger is likely to significantly preclude other firms in the industry from having an opportunity to expand or preclude other firms from entering. And the effect of that would presumably lead then to greater potential for collusive or interdependent behavior.

But I must confess that those areas are not ones that you can predict with great ease, and I think the Justice guidelines reflect the difficulty of making those tradeoffs.

Senator METZENBAUM. Thank you, Commissioner Clanton.

Mr. Miller, do you think that under your administration, the FTC will make more vertical merger challenges, a lesser number, or about the same number? Can you give us any prediction as to what you think your activity will be?

I think your answer can be based upon a presumption that there will indeed be more mergers month after month and year after year; there certainly have been since this administration came into office.

Chairman MILLER. Well, Senator, let me respond on your predicate by noting that it is true that, according to some information compiled by General Baxter and his chief economist Larry White, the number of acquisitions was greater in 1981 than it was in 1980—and it looks like at least on an annualized basis, the number of mergers and acquisitions probably will be about the same for 1982. However, while that number is higher than it was in either 1978, 1979, or 1980, it is substantially below the number when this merger activity reached its peak in 1968, and is substantially below the number of mergers and acquisitions even as late as 1973.

I dare say the resources of the Federal Trade Commission committed to vertical mergers in 1973 were less than today, and in 1968 surely were. I do not have those numbers at my fingertips, but I feel fairly confident in saying that.

We do have in our budget for fiscal 1983 considerable resources devoted to vertical mergers. We have an expectation of reviewing vertical mergers. We have investigated a number of vertical merger cases since I have been at the Commission.

I would say this: Consistent with what the evidence tends to show and the legal and economic analysis, we should be less concerned generally with vertical mergers than we have been in the past.

I think that our efforts at the Federal Trade Commission will focus on the aspects of vertical mergers that might substantially lessen competition or tend to create a monopoly, as the law says.

I would say that we would review vertical mergers, but we will be guided by the law and the evidence in making our decisions. It is hard to predict exactly how many mergers we will have. It is hard to predict how many will be forthcoming to us for review. It is hard to predict how many we will take issue with.

Senator METZENBAUM. That is a lengthy answer, but as you well know, you did not answer my question.

Chairman MILLER. I am sorry.

Senator METZENBAUM. Back in 1968 and 1973, there were different kinds of circumstances that were existing at that time. You had this whole question of PE ratios, making it possible for the company with a 30-time PE ratio to buy a company with a 20-time PE ratio and thereby increase its earnings per share. It was sort of a numbers game.

You do not have that at the moment. You now are making most mergers for cash dollars which do have a certain market value.

Now, the question is, in view of the fact of the increased number of mergers, and basing it on a relative factor of how many there have been in the past and assuming there will be a greater number, or assuming the same number, do you anticipate that the FTC will bring a higher number of challenges for mergers that are being made, a lesser number, or about the same, as administrations of past years have done, going back 10 years?

Chairman MILLER. Well, Senator, it hinges on which assumption I make. If I make the assumption that there will be many more vertical mergers, then, everything else equal, we would have more vertical merger cases at the Federal Trade Commission. If it is less, it will be accordingly less.

I think, everything else equal, my opinion is we will issue fewer complaints in the vertical merger area than in past years. But the Federal Trade Commission really did not bring all that many vertical merger cases before I arrived at the Commission.

You have to consider each one on its evidence. We will have to review them all, but if I had to make a prediction, that would be it. But I want to assure you it is not because I am simply saying that I would not vote for any vertical merger case. We have to look at them on the evidence. It depends on the characteristics of the particular merger that comes to us for review.

Senator METZENBAUM. Thank you, Mr. Miller, and I look forward to hearing from you further on the question of the gasoline price rise. I appreciate your appearing before us, and Commissioner Clanton, and I think we owe it to General Baxter to give him equal time.

Chairman MILLER. We shall get back to you straightaway. Sir, thank you for the opportunity.

Senator METZENBAUM. Thank you.

[Prepared statement of the Federal Trade Commission and response to question by Senator Specter follow:]

STATEMENT OF FEDERAL TRADE COMMISSION CONCERNING HORIZONTAL MERGERS

I. Background

The Federal Trade Commission ("Commission") and the Antitrust Division of the Department of Justice ("Antitrust Division") have been reexamining the legal and economic basis for horizontal merger policy. In light of enforcement experience and more recent economic research, the two agencies have both concluded that continued reliance on the Department of Justice's Merger Guidelines, promulgated in 1968 ("1968 Guidelines"), is no longer appropriate. In order to revise the 1968 Guidelines and incorporate new factors that are relevant to current horizontal merger analysis, the Commission and the Antitrust Division formed working groups of lawyers and economists to evaluate past experience under the 1968 Guidelines and to recommend specific modifications. The staffs of both agencies have worked closely in this endeavor. In addition to their research and analytical work, they have also solicited and carefully examined the views of the private bar, the academic and business communities, as well as the public at large.

The Commission is issuing this Statement to express its collective judgment of the reasons why it supports changes in the 1968 Guidelines and to highlight the principal considerations that will guide its horizontal merger enforcement. However, the Department of Justice's 1982 revisions to the 1968 Guidelines will be given considerable weight by the Commission and its staff in their evaluation of horizontal mergers and in the development of the Commission's overall approach to horizontal mergers. 1/

II. Market Share Considerations

Congress enacted section 7 of the Clayton Act to prevent the corporate accumulation of market power through mergers. 2/ The subsequent amendment to the Clayton Act, 3/ while primarily focusing on competitive considerations, 4/ also reflected Congress' concern about the overall social and political ramifications of economic concentration attributable to merger activity. 5/ Legal analysis of horizontal mergers, however, has focused on the extent to which these mergers confer market power on the acquiring firm or enhance the ability of firms to collude, either expressly or tacitly.

In measuring these market power effects, the courts, the Commission and the Antitrust Division have traditionally looked to market share data and derivative concentration ratios as the principal indicators of market power. Their reliance on such evidence was founded on early empirical economic literature indicating a significant positive relationship between concentration levels, industry performance and profits. 6/ In addition, market share data provided an easily ascertainable and relatively objective benchmark to evaluate the potential effects of horizontal mergers.

More recent empirical economic research 7/ and well over a decade of practical experience in analyzing and evaluating horizontal mergers, however, have led the Commission to conclude that proper consideration of market realities justifies some revision of market share benchmarks and greater consideration

NOTE.--Footnotes appear at end of article.

of evidence beyond mere market shares when such evidence is available and in a reliable form. Whether utilizing the Herfindahl-Hirschman index or other concentration measures, the Commission believes that an increase in the threshold market shares is clearly justified on at least three bases. First, current economic analysis suggests that the low combined market share thresholds contained in the 1968 Guidelines, e.g., 8 percent and 10 percent, are unlikely to contribute to oligopolistic behavior or market dominance. 8/ Second, the threshold levels in the 1968 Guidelines do not capture as fully as possible economies of scale achieved through merger. 9/ Third, the relationship between the number and relative size of firms in the relevant market was not taken into account in the 1968 Guidelines. Recent studies also suggest that poor market performance may be partly a function of firm size disparity. Thus, although far from definitive, this research suggests that particular attention should be given to disparity in market shares between the top one or two firms and the remaining firms in an industry. 10/

For these reasons, while the Commission will continue to look to market share data as an important indicium of the likely competitive effects of a merger, a more refined treatment of that data is in order.

III. Non-Market Share Considerations

Current statistical information helps to provide a good snapshot of an industry, but consideration of additional market characteristics, entry barriers being the major example, may provide a clearer and more accurate picture of the competitive dynamics of that industry. Such an inquiry may reveal whether any market power conferred by the merger is likely to persist over time and whether market conditions are conducive either to the exercise of individual firm market power or to collusive-type behavior.

The Commission recognizes, of course, that any type of market analysis, including reliance on market shares, inevitably carries with it an element of imprecision. For example, relevant evidence may be difficult to obtain or, where it is available, may be fragmentary and inconsistent. Further, evidence peculiarly within the control of the parties to the proceeding may be subject to bias and be difficult to verify. Nevertheless, the Commission believes that consideration of factors other than market shares, including qualitative factors, can be useful and desirable. If proper allowance is given to the evidentiary limitations, a balance can be struck that achieves the twin objectives of maintaining reasonable predictability in merger policy while enhancing the quality of the analysis and the correctness of the ultimate outcome.

The following discussion of non-market share factors will serve to define the scope of the merger inquiry and to prevent the analysis from becoming a limitless search for any evidence of possible relevance, since an open-ended examination may prevent the Commission and the courts from providing meaningful and timely guidance to business.

A. Market Power/Duration Factors

As we have noted, market share data can serve as an important preliminary surrogate measure of market power. For a variety of reasons, however, that indicator may not always accurately measure the market power of merging firms. The critical task, then, is to

isolate and evaluate those additional factors that are also relevant to the assessment of market power effects.

(1) Marketwide Conditions

Ideally, if we could measure all relevant demand and supply elasticities, we could arrive at relatively precise estimates of market power. 11/ Such evidence, however, is rarely, if ever, available and is not readily susceptible to direct measurement. Therefore, other criteria must be utilized to determine the probable impact of a merger. The most probative criteria include: entry barriers; concentration trends (including the volatility of market shares); technological change; demand trends; and market definition. These factors are interrelated and primarily address industrywide conditions rather than firm-specific characteristics.

The issue of entry barriers is perhaps the most important qualitative factor, for if entry barriers are very low it is unlikely that market power, whether individually or collectively exercised, will persist for long. 12/ Conversely, if entry barriers are quite high, the effect may be to exacerbate any market power conferred by the merger. Of course, the evidence relating to entry barriers may not always point clearly to the conclusion that a merger should or should not be allowed. On the other hand, evidence of actual entry, especially recent and frequent new entry, is highly probative, as is evidence of failed entry or the absence of entry over long periods of time. Besides mere entry, effective competition might also depend upon a firm's achieving a certain scale of operation. Evidence of substantial expansion by firms already in an industry, especially non-dominant firms, may persuasively indicate that barriers to larger scale are not high. Conversely, evidence of frequent entry by fringe firms on a small scale, without significant expansion, may also suggest the existence of barriers to larger scale.

Market power also may be harder to exercise or less likely to endure in the face of rapid technological change or significant upward shifts in demand. Moreover, this kind of evidence may shed light on questions of market definition and the market's propensity towards collusive interdependence. New technology, for example, may signal that the market is being transformed and that traditional boundaries do not accurately measure the degree of product substitutability which actually exists. If these trends are strong, they are likely to result in new entry, declining concentration or unstable market shares. These issues are closely intertwined. Market share fluctuations may represent overt manifestations of underlying market forces and, as such, provide a very useful picture of market dynamics. Of course, like other evidence, the value of such data depends upon the magnitude and likely duration of the shifts that are occurring. Small deviations in market shares, even if they recur on a frequent basis, may be of little significance.

Additionally, the issue of market definition is relevant in determining whether market power exists and can be exercised successfully. The more carefully the lines are drawn, the more confidence can be placed in the predictive value of market share data; but market boundaries cannot always be drawn with fine precision. Where the boundaries are highly blurred, it may be appropriate to take that fact into account, especially at the margin where the market shares are not particularly high. 13/

These factors are important in revealing whether the market shares overstate or understate the competitive impact of a merger. The weight to be assigned this evidence is a critical issue since, as noted above, it will often be impossible to make fine distinctions based on the quantity and quality of the non-statistical information. For instance, the fact that demand is increasing or new products are being introduced does not necessarily mean that the market share data should automatically be discounted by some factor. Rather, it is important to look at overall trends to see where the market is heading and at what rate.

Where all of the non-market share evidence consistently points in the same direction, its value will be high. Such evidence will be of even greater significance where the market shares are in the low to moderate range. On the other hand, if the anticompetitive potential of a merger is large, as predicted by the combined market shares of the merging parties, other non-market share factors may appropriately be given less weight, even if the adverse effects are relatively shortlived. To be sure, merger analysis properly focuses primarily on long-term competitive implications, but short-term effects should not be ignored, particularly if they are substantial.

(2) Firm-Specific Characteristics

So far, we have focused on marketwide conditions that may bear on the competitive effects of a merger. Factors peculiar to the merging parties can also be of relevance, although some caution should be exercised since this kind of evidence is harder to verify. 14/ The most important type of evidence relates to the failing company doctrine. However, it is frequently argued by parties to a merger that financial weakness should be considered as a defense by the enforcement agencies. While not endorsing this approach in all its dimensions, 15/ the Commission does believe that evidence of individual firm performance can be of use in evaluating the probable effects of a merger, primarily if it indicates that a firm's market share overstates its competitive significance. For example, poor financial performance may accompany new entry or technological change, which itself may be evidence of the firm's declining competitive significance and its lack of prospects for future success or it may be indicative of other changes taking place in the market. 16/

Another issue related to individual company performance concerns the acquisition of firms with small market shares whose competitive potential is unique. 17/ Like the previous discussion, the issue here is not so much whether the firm is performing well per se, but whether its presence in the market is having some discernible impact on competition. For example, is the firm a disruptive force in an industry that is otherwise susceptible to oligopolistic behavior? Does it have a unique technological capability that can be capitalized to advantage? Obviously, these considerations have more force in markets that are highly concentrated and where the acquiring firm is one of the industry leaders. Thus, there may be situations where the market shares of acquired firms clearly understate their competitive significance. This kind of inquiry most likely will involve combined market shares above the Guidelines. but it could, on occasion, involve acquisitions where the combined market shares fall slightly below the triggering threshold levels.

B. Factors Facilitating Collusion

In the preceding section, market conditions that may facilitate or hinder the exercise of market power were discussed. This section focuses on market characteristics that may enhance or detract from the ability of firms to collude or to raise prices and restrict output by interdependent behavior. Oligopolistic markets, or at least markets with few substantial firms, are more conducive to interdependent behavior than a market without such characteristics. However, the number and size of the firms may not reveal the full picture. Other factors may affect the relative ease or difficulty of achieving or maintaining interfirm coordination. Thus, the Commission believes that it is appropriate to take some account of these considerations, particularly at the pre-complaint stage. The most relevant factors appear to be: the homogeneity (or fungibility) of products in the market; the number of buyers (as well as sellers); the similarity of producers' costs; the history of interfirm behavior, including any evidence of previous price-fixing by the firms at issue; and the stability of market shares over time.

The Commission recognizes, of course, that knowledge of the dynamics of collusion or price coordination is far from complete. Moreover, in mergers where individual market power concerns predominate, issues of collusion will be of less importance. Nevertheless, some consideration of these issues should, at the very least, help the courts and enforcement agencies to sort out those cases where there appears to be little, if any, likelihood that an acquisition will contribute significantly to oligopolistic interdependence. Conversely, where the evidence of these factors points strongly in the opposite direction, we will want to examine a merger more closely, even if the market shares are relatively low.

IV. Efficiency Considerations

Mergers may enhance the efficiency of the combining firms in such diverse areas as management, distribution and production. The difficult issue is whether such efficiency gains should be considered, at least as a partial offset to the potential anti-competitive effects of a merger, given the inherent difficulty of accurately predicting and measuring certain efficiencies. 18/ Unlike the issues discussed previously, the question here is not whether efficiency considerations reduce or enhance the market power effects of a merger, but whether efficiencies should be treated as an independent countervailing factor in merger analysis.

There are two ways in which merger guidelines might take efficiencies into account. One way is by raising the market share thresholds so that economies of scale generally can be realized to the fullest extent possible. The Commission supports an adjustment in the numerical criteria, in part, for this reason. Such an approach, however, may not account for all possible efficiencies. To accomplish the latter objective, an efficiencies defense could be allowed in individual cases. Of necessity, such a defense would require an assessment of both the magnitude of the efficiencies anticipated from the merger and the relative weight to accord this evidence vis-a-vis the potential market power effects of the merger.

To minimize measurement difficulties, it has been suggested that an efficiencies defense could be limited to measurable operating efficiencies, such as production or plant economies of scale. 19/ These efficiencies are also more likely to be of

the kind that may eventually represent an improved state of the art available to all producers. 20/ While such evidence is appropriate for consideration by the agency in the exercise of its prosecutorial discretion at the pre-complaint stage, 21/ the Commission believes that there are too many analytical ambiguities associated with the issue of efficiencies to treat it as a legally cognizable defense. 22/ To the extent that efficiencies are considered by the Commission as a policy matter, the party or parties raising this issue must provide the Commission with substantial evidence that the resulting cost savings could not have been obtained without the merger and clearly outweigh any increase in market power.

V. Failing Company Defense and Related Arguments

The failing company defense recognizes a general preference for having assets productively utilized rather than withdrawn from a market. Whether assets will in fact be withdrawn is a difficult question and depends heavily on evidence under the control of the affected firm. For this reason, the failing company doctrine imposes rigorous requirements on firms seeking to invoke it. 23/ In addition, the restrictions contained in the doctrine reflect the fact that the defense is absolute, regardless of any increased market power accruing to the acquiring firm by virtue of its purchase of the failing company's assets.

Because of proof burdens and general competitive considerations, the suggestion has been made that the doctrine should be relaxed to allow greater latitude for a troubled company to sell its assets to the highest bidder. For example, the doctrine could be liberalized to allow for a failing division defense or to permit a sale to the least objectionable purchaser available, where the technical requirements relating to business failure are otherwise not met, but a substantial risk exists that operations will cease if a merger is not consummated.

An increasing number of mergers evaluated by the Commission involve diversified firms seeking to divest a division or subsidiary. To require subsidization of a division or continuation of unprofitable operations carries its own costs to competition, including diminished efficiency and innovation. Such a result encourages firms to make unsound investments and leads to the inefficient use of capital. 24/ The Commission's past reluctance to give legal status to a less-than-failing company defense stems from the difficulty of determining whether the costs of continued operation (until another acceptable purchaser, if any, is found) outweigh the market effects of the proposed merger. For example, with respect to the failing division argument, because of the potential facility to shift overhead and losses among divisions, an individual unit can be made to appear in worse fiscal condition by its parent than in fact is the case. 25/

In light of these considerations, the Commission will take into account evidence of a failing division or other similar evidence that falls short of the technical requirements of the failing company defense. However, due to the difficulties of proof, consideration of this evidence will be limited to the Commission's exercise of its prosecutorial discretion. 26/ With respect to any such analysis, the Commission will look closely at the following factors: the extent and history of a firm's financial difficulties; whether established accounting procedures have been followed; whether a good faith effort to find another purchaser for the firm or division has been made; and whether the proposed purchaser is the least anti-competitive purchaser willing to acquire the firm or division.

VI. Market Definition

The predictive value of evidence concerning competitive effects is directly affected by the manner in which the relevant product and geographic markets are defined. Thus, issues of market definition are critically important to sound merger analysis.

A. Product Market

The purpose of product market analysis is to ascertain what grouping of products or services should be included in a single relevant market. Where the cross-elasticity of demand for separate products or services is high, they normally will be within the same product market. Similarly, a high cross-elasticity of supply tends to suggest the existence of a common product market. Therefore, the issue of whether related products or services place a significant constraint on the ability of merging firms to raise prices, limit supply or lower quality is central to evaluating the competitive effects of a horizontal merger.

Cross-elasticity of demand (or supply) is best measured by the change in the quantity of another product induced by a price rise in the merged firm's product, either over time or in different geographic markets. Since direct evidence of cross-elasticities is generally unavailable, the courts and enforcement agencies look to other, less direct market indicia. For example, the existence of separate product markets may be evidenced by: the persistence of sizeable price disparities for equivalent amounts of different products; the presence of sufficiently distinctive characteristics which render a product suitable only for a specialized use; the preference of a number of purchasers who traditionally use only a particular kind of product for a distinct use; or the judgment of purchasers or sellers as to whether products are in fact competitive. In addition, where firms routinely study the business decisions of other firms, including their pricing decisions, such evidence may reflect a single product market. These secondary indicia, however, will be closely scrutinized because of the inherently imprecise and sometimes self-serving nature of this type of evidence. Finally, investment, marketing and production plans may also evidence whether a firm may competitively enter into the production and sale of another good. Particularly where such information is detailed and provides the basis for a firm's decision, it will be considered in the product market analysis.

B. Geographic Market

This component of market definition focuses on the extent to which different geographic areas should be combined into a single relevant market. The issue is whether producers of the merged firm's product in other geographic areas place a significant constraint on the ability of the merged firm to raise price or restrict output. As a general proposition, an area is a separate geographic market if a change in the price of the product in that area does not, within a relevant period of time, induce substantial changes in the quantity of the product sold in other areas.

The Commission will consider the following factors relevant to this determination: the relationship between price and quantity (or, if evidence of such relationship is shown not to be available, evidence of independent price movement, collusive pricing or price discrimination within a single area);

barriers to trade flows, e.g., high transportation costs, time required to make deliveries or municipal, state or federal regulation; and shipping patterns (absence of shipments, however, does not necessarily indicate separate geographic markets because, in some circumstances, a slight price rise in one area could precipitate shipments from other areas). Evidence of shipments may be particularly probative when it reflects long-held patterns of trade and industry perceptions.

An additional consideration relevant to geographic market definition concerns the extent to which foreign markets should be included in the analysis. There is increasing evidence that national boundaries may not fully reflect trade patterns or competitive realities in certain instances. At the same time, evidence relating to foreign markets may be very difficult to obtain. Nevertheless, while these limitations may preclude the delineation of larger-than-domestic markets, some consideration should be given to this issue in determining the competitive significance of domestic market share data.

FOOTNOTES

1/ While the Commission supports the Department of Justice's decision to revise the 1968 Guidelines, individual Commissioners, however, may not endorse each specific revision that has been proposed.

2/ Clayton Act, Pub. L. No. 63-212, 38 Stat. 730 (1914) (codified at 15 U.S.C. § 18 (1976)).

3/ Celler-Kefauver Act, Pub. L. No. 81-899, 64 Stat. 1125 (1950) (codified at 15 U.S.C. §§ 18, 21 (1976)).

4/ See IV P. Areeda & D. Turner, Antitrust Law 8-14 (1980).

5/ For a discussion of Congress' interest in the non-economic aspects of mergers, see Bok, "Section 7 of the Clayton Act and the Merging of Law and Economics," 74 Harv. L. Rev. 226, 233-49, 306-07 (1960). See also Pitofsky, "The Political Content of Antitrust," 127 U. Pa. L. Rev. 1051 (1979).

6/ See IV P. Areeda & D. Turner, supra note 4, at 52-54. For a discussion of the relevant literature, see generally Pautler, "A Review of the Economic Basis for Broad-Based Horizontal Merger Policy," Federal Trade Commission Staff Working Draft 18-27 (October 1981).

7/ See literature survey contained in Pautler, supra note 6, at 28-30, 61-74.

8/ Id.

9/ See II P. Areeda & D. Turner, supra note 4, at 291-98; R. Posner, Antitrust Law 112-13 (1976); Fisher & Lande, "Efficiency Considerations in Merger Enforcement," 91 Yale L.J. _____, at Section III (1982)(forthcoming). In certain circumstances, an increase in threshold levels will enhance the ability of smaller firms to exit from the market, thereby facilitating entry. See Pillsbury Co., 93 F.T.C. 966, 1041-42 (1979).

10/ For a detailed discussion of this research, see Pautler, supra note 6, at 78-85.

11/ Landes & Posner, "Market Power in Antitrust Cases," 94 Harv. L. Rev. 937, 939-43 (1981).

12/ See F. Scherer, Industrial Market Structure and Economic Performance 5, 11, 236 (2d ed. 1980); G. Stigler, The Theory of Price 220-27 (3d ed. 1966); Demsetz, "Barriers to Entry," 72 Am. Econ. Rev. 47 (1982).

13/ See Coca-Cola Bottling Co., 93 F.T.C. 110 (1979); SKF Industries, Inc., 94 F.T.C. 6, 86-87 (1979).

14/ See United States v. General Dynamics Corp., 415 U.S. 486, 506-08 (1974); Kaiser Aluminum & Chem. Corp. v. F.T.C., 652 F.2d 1324, 1338-39 (7th Cir. 1981); Pillsbury Co., 93 F.T.C. 966, 1038-39 (1979).

15/ The courts and the Commission have held that evidence of poor financial performance alone is insufficient, as a matter of law, to sanction a merger. See United States v. General Dynamics Corp., 415 U.S. 486 (1974); Kaiser Aluminum & Chem. Corp. v. FTC, 652 F.2d 1324, 1338-39 (7th Cir. 1981); Pillsbury Co., 93 F.T.C. 966, 1036-39 (1979).

16/ See Pillsbury Co., 93 F.T.C. 966 (1979).

17/ See United States v. Aluminum Co. of America, 377 U.S. 271, 280-81 (1964); Stanley Works v. FTC, 469 F.2d 498 (2d Cir. 1972), cert. denied, 412 U.S. 928 (1973).

18/ See IV P. Areeda & D. Turner, supra note 4, at 146-99; Fisher & Lande, supra note 9.

19/ See IV Areeda & Turner, supra note 4, at 175-96. For a discussion of operating efficiencies and methods of proof, see Fisher & Lande, supra note 9, at Sections III(A), V(A); Muris, "The Efficiency Defense Under Section 7 of the Clayton Act," 30 Case W. Res. L. Rev. 381 (1980).

20/ Where efficiencies flow from factors peculiar to the merged firms, such as improved quality of management, their contribution to the economy as a whole is more problematic.

21/ This procedural approach has been suggested by Williamson, "Economies As An Antitrust Defense Revisited," 125 U. Pa. L. Rev. 699, 734-35 (1977), and by the Section 7 Clayton Act Committee Task Force of the American Bar Association Antitrust Section, "Proposed Revision to the Justice Department's Merger Guidelines" at 41 (1982).

22/ Chairman Miller disagrees with this conclusion and believes that scale-type efficiencies should be considered as part of the legal analysis, consistent with the statutory scheme underlying § 7 of the Clayton Act, see Muris, supra note 19.

23/ See, e.g., United States v. General Dynamics Corp., 415 U.S. 486 (1974); United States v. Greater Buffalo Press, Inc., 402 U.S. 549, 555-56 (1971); Citizens Publishing Co. v. United States, 394 U.S. 131, 136-39 (1969); Pillsbury Co., 93 F.T.C. 966, 1031-33, 1036-39 (1979); Reichhold Chems., Inc., 91 F.T.C. 246, 288-91 (1978), aff'd, 598 F.2d 616 (4th Cir. 1979).

24/ Refusal to consider evidence of a failing division has been characterized as unfair in that it requires diversified firms "to absorb losses that independent companies can avoid, or to take risks which independent lenders would deem improvident." IV P. Areeda & D. Turner, supra note 4, at 112.

25/ See Dean Foods Co., 70 F.T.C. 1146, 1285 (1966); Farm Journal, Inc., 53 F.T.C. 26, 47-48 (1956). The lower courts, however, are clearly divided on the issue of the failing division. Compare FTC v. Great Lakes Chem. Corp., 1981-2 Trade Cas. (CCH) ¶ 64,175 at 73,592 (N.D. Ill., July 23, 1981); United States v. Reed Roller Bit Co., 274 F. Supp. 573, 584 n.1 (W.D. Okla. 1967); and United States v. Lever Bros. Co., 216 F. Supp. 887 (S.D.N.Y. 1963) with United States v. Blue Bell, Inc., 395 F. Supp. 538, 550 (M.D. Tenn. 1975) and United States v. Phillips Petroleum Co., 367 F. Supp. 1226, 1259-1260 (C.D. Cal. 1973), aff'd per curiam, 418 U.S. 906 (1974). For a discussion of the problems associated with accurately assessing failing division evidence, see generally Conglomerate Mergers - Their Effects on Small Business and Local Communities: Hearings Before the Subcommittee on Antitrust and Restraint of Trade Activities Affecting Small Business of the House Committee on Small Business, 96th Cong., 2d Sess. 49-57, 91-130, 368-435 (1980).

26/ Chairman Miller would permit evidence of a failing division to be raised as a legal defense in a merger proceeding.

FEDERAL TRADE COMMISSION
WASHINGTON, D. C. 20580

OFFICE OF THE CHAIRMAN

SEP 02 1982

August 30, 1982

The Honorable Strom Thurmond
Chairman
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of July 30, 1982, enclosing a question raised by Senator Specter in connection with my testimony before the Committee on the Judiciary on July 21, 1982, regarding Federal Trade Commission merger policy. Enclosed you will find a written response to the question for inclusion in the hearing record.

Sincerely yours,

James C. Miller III
Chairman

Enclosure

Question: I understand that you cannot discuss the Gulf-Cities Service merger currently pending before the Commission. However, it does appear that the oil industry provides an important example of an industry where most mergers will carry a presumption of lawfulness under the DOJ Herfindahl index. In the Mobil/Marathon case, the Herfindahl index for retail gasoline sales in Ohio was 1,058 and the increase in concentration induced by the merger would have been less than 50, thus putting the merger into a presumptively "safe harbor." Do you believe that the FTC policy statement differs sufficiently from the DOJ guidelines to ensure that such oil company mergers will continue to be subject to close scrutiny?

ANSWER: Both the Commission and the Antitrust Division merger enforcement statements reflect general agreement on the appropriate criteria to be applied in analyzing the competitive impact of mergers. Consequently, I do not believe that substantial differences between the FTC and DOJ policy statements exist that indicate different conclusions by the two agencies on particular oil company mergers.

The recent attempted acquisitions of Marathon by Mobil Corporation and Cities Service by Gulf Oil Corporation provide examples of the application of the analytical approach embodied in the Commission's policy statement to specific petroleum industry acquisitions. Based on its analysis of the Gulf-Cities Service merger, the Commission concluded that the combination of the two companies might tend substantially to lessen competition in the production and distribution of jet fuel, in the wholesale distribution of gasoline, and in the transportation of petroleum products in various geographic regions running from the Gulf Coast refining center up through much of the East Coast of the United States. Both in Gulf-Cities Service and in Mobil-Marathon, the Commission found reason to believe that the proposed acquisitions might also lessen competition substantially in the wholesale distribution of gasoline within a number of terminal service areas roughly corresponding to concentrations in Standard Metropolitan Statistical Areas ("SMSAs").

It should be emphasized that the FTC's determination to challenge both mergers followed an initial examination of the Herfindahl indices in various markets, as an important tool for focusing on areas of specific antitrust concern. In large part because

horizontal overlaps in various product and geographic markets in a significant number of areas surveyed in both Mobil-Marathon and Gulf-Cities Service displayed substantial increases in the Herfindahl indices, the Commission decided to analyze further the competitive impact of the two mergers in such markets, based on qualitative factors discussed in both the FTC and DOJ enforcement statements. The Commission's approach in both of these investigations was consistent with that enunciated in the Commission's enforcement policy statement: namely, that the Commission will accord "considerable weight" to the numerical standards in the revised DOJ enforcement guidelines in making the threshold determination of whether a horizontal merger warrants further antitrust scrutiny. In both cases this approach dictated intensive antitrust review, on the basis of which the Commission sought to prevent consummation of these two major petroleum industry mergers. Thus, I believe the present enforcement policy of both the FTC and DOJ will assure rigorous antitrust review of such mergers.

SEPARATE STATEMENT OF COMMISSIONER PERTSCHUK

Though I agree with most of Chairman Miller's analysis of the Commission's Statement Concerning Horizontal Mergers, I wish to give a somewhat different interpretation of certain specific points. First, I do not believe, as a matter of enforcement decisionmaking, that the Commission is placing more emphasis than the Justice Department on qualitative factors. While our Statement discusses these factors rather than numerical criteria, that is because we felt it was most useful to do so, not because we wanted to emphasize them more in evaluating competitive consequences.

Second, I do not believe that the position of a majority of the Commission on considering efficiencies and the failing company defense differs from that of the Justice Department. Although we use different terminology, I view our policies as the same.

Where we may differ from Justice is in defining markets and evaluating the significance of entry barriers. This area is necessarily imprecise, however, and it would be impossible to state with certainty that the two agencies would view each individual question which arises in this area in the same way, even if the Justice Department and the FTC had precisely the same philosophy about antitrust.

For purposes of business planning and antitrust counseling, the most important aspect of the guidelines is market share thresholds. There, I believe that the FTC will be guided by the Justice guidelines, and the public should not expect there to be significant differences in our reliance on these numerical critera.

Senator METZENBAUM. Assistant Attorney General Baxter, I gather you have not submitted a statement in advance to the committee.

Mr. BAXTER. I have not prepared a statement today, Senator.

Senator METZENBAUM. May we ask you to make your presentation and hold it to 10 minutes?

STATEMENT OF HON. WILLIAM F. BAXTER, ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, U.S. DEPARTMENT OF JUSTICE

Mr. BAXTER. I will be briefer than that, if I may, Senator. I would say only that, as I announced 15 months ago, I thought the preparation of new merger guidelines was a very, very important

project. The gulf between enforcement practice, and indeed the gulf between judicial decisions and the old guidelines, had become progressively wide with the passage of years.

The Antitrust Division invested very substantial resources in this project over the last year. I am personally delighted with the content of the guidelines. I think the Division has done an excellent job with them. The efforts of many, many people went into them, and I am happy to be able to be here and talk about them today.

Senator METZENBAUM. Is that it?

Mr. BAXTER. Thank you.

Senator METZENBAUM. Let me ask you a question before we get into the guidelines. Do you anticipate responding to my question to you or to my suggestion to you that the Antitrust Division investigate the reason for gasoline prices going up in view of the oil glut and the fact that the oil companies have deliberately closed down their refineries?

I wrote you that letter, I would guess, 4 weeks ago or something like that. Let us see; maybe I can tell you when I wrote it—June 15. It was about 4 weeks ago. I have not heard from you.

Mr. BAXTER. I am not surprised that you have not heard from me, Senator. I did not know about that letter until 5 minutes ago when you mentioned it to Mr. Miller. I will have to chase it down when I get back to the Division. I just do not know what has become of it, but I will do that.

Senator METZENBAUM. May I make a suggestion? Maybe somebody in the Division ought to be told that when a Senator writes to an attorney general, at least they ought to bring the matter to his attention, whether they agree or disagree. I do not think that is too bad a policy.

Mr. BAXTER. I think that is an admirable policy. Indeed, I think we have it in force, but it seems not to have been implemented on this particular occasion.

Senator METZENBAUM. I understand full well.

Now, let me go over to another subject before we get into the merger guidelines. On February 22, 1982, you sent a memo to all the attorneys in the Antitrust Division and you stated as follows:

> Today, I encountered the most recent of a very large number of documents generated within the Division over the past year which asserted that private parties had violated section 1 by means of an agreement which stabilized prices. Usually, I encounter that word in a sentence which employs it conjunctively with one or more other words, frequently "fixed" or "raised."
>
> I suspect that this usage is derivative from the outrageous generalization of Justice Douglas in the *Socony Vacuum* case to the effect that parties commit a per se violation of section 1 to the extent that they raised, lowered, or stabilized prices.
>
> To suggest that all private agreements which have the effect of stabilizing prices constitute antitrust violations is idiocy of an even higher order than the suggestion that agreements lowering prices constitute such violations; that you would, for example, condemn all arrangements pertaining to futures markets.

You go on to say:

> Over the months ahead, as you have occasion to employ the many items of boilerplate that reside in our files, I ask you to strike the word "stabilize" whenever it is used in this context. I also ask that you perform perhaps the more difficult task of excising it from your official usage.

Now, that was in February. In June, in *Arizona* v. *Maricopa County Medical Society,* the Supreme Court stated that—in fact,

what you had said in the past was that you rejected Supreme Court decisions on the theory that if the Court could decide the cases again, it would accept your theories.

Now, the Court, in the *Maricopa County* decision, specifically stated:

> We reaffirm what we said in the *United States* v. *Socony Vacuum Oil Company* case.

And then they say:

> Under the Sherman Act, a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal, per se.

That being the case, have you advised your staff that the description of the outrageous generalization of Justice Douglas and the description of that position of being idiocy of an even higher order—have you advised your staff that in this instance, you erred and that the Supreme Court is the law of the land, and that they do not have to excise all the words and language and that they do not have to do a lot of other things that you so specifically directed them to do, or do you say, "I do not care what the Supreme Court says?"

Mr. BAXTER. No; I have not done any of those things, Senator. The generalization that every private arrangement that is intended to stabilize prices is unlawful is still an outrageous generalization and, of course, the *Maricopa County* case did not hold otherwise.

They did repeat the language from *Socony,* to be sure, that I had urged my lawyers not to repeat, precisely because it did embody a generalization which, so far as I am aware, has never been the foundation of any decided case.

The *Maricopa County* case, of course, involved horizontal minimum price fixing by an overwhelming preponderance of the actors in a relevant market, and the outcome of that case was quite consistent with the brief we had filed in the case.

Senator METZENBAUM. I think the real question that I am asking you is the same one I have asked you on previous occasions, and that is does the Assistant Attorney General for Antitrust feel an obligation for his department and himself to conform with previous Supreme Court decisions and the acts of Congress, or do you still feel you have the right to reject those opinions and the acts of Congress based upon your own personal notions as to what the law should or should not be?

Mr. BAXTER. Well, I have never expressed the view that the Assistant Attorney General is free to reject any applicable Court decision or statute. There is not any question about the current decisions of the Court being the law of the land.

There is a very considerable difficulty in deciding what the state of judicial law is at any particular point in time; in particular, it is difficult to determine the status of older decisions which have never explicitly been overruled but are entirely inconsistent with the tone and mode of analysis of later decisions. That is not an exercise that can be performed by reading quotations out of older Supreme Court decisions.

Senator METZENBAUM. But the *Maricopa* case does hold, does it not, that stabilization or actions which have the effect of stabilization are illegal, per se?

Mr. BAXTER. No; it holds that horizontal minimum price-fixing agreements among a preponderant share of the sellers in the market are illegal, per se, by a 4-to-3 decision.

Senator METZENBAUM. Well, it does not matter whether it is 4 to 3 or not. That is still the law of the land, is it not?

Mr. BAXTER. It is the law of the land, but it does matter because it tells you something about likely stability, since it was a minority of the Supreme Court that provided the majority opinion.

Senator METZENBAUM. When you appeared before, you indicated that you thought that if the Court had the chance to reexamine some of these issues, they would change. Now, we have the *Maricopa* case; they did not change. So, you come before us and, again, you indicate your disapproval of their decision and point out that it was only a 4-to-3 decision and that maybe one of these days they will change that.

Now, I cannot do that as a law-abiding citizen, and that lady cannot do that as a law-abiding citizen. Why can you, as the Assistant Attorney General, indicate that you are not in accord with it?

This language is very clear. You say it does not hold stabilization, per se, illegal, but that is exactly what they said.

> We reaffirm what we said in *United States* v. *Socony Vacuum.* Under the Sherman Act, a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal, per se.

You just said to me that that is not what they held.

Mr. BAXTER. I did say it is not what they held, and I say again it is not what they held. There is a difference between what a court says in the course of an opinion and what a case holds. What a case holds pertains to the facts that are before the court in that particular case, and the holding is necessarily limited to those facts.

There were no facts pertaining to stabilization in the *Maricopa County* case. The holding pertains to the record that was before the Court. The Court says many things in the course of an opinion, but it has nothing inescapable to do with the holding in the case.

Senator METZENBAUM. Mr. Baxter, how many years did you practice law?

Mr. BAXTER. I have practiced law since 1956.

Senator METZENBAUM. Well, you have been in the world of academia for what portion of that time?

Mr. BAXTER. I have been in the world of academia for a very large portion of the time, but I practiced law through the entire time I was there.

Senator METZENBAUM. But you have actually been a professor of law all that time. What is just amazing me as I sit here is I came from being a practicing lawyer and I have just never heard anybody in a courtroom, I have never heard a court, I have never heard anybody say what you just got through saying, and that is that the case only speaks for the facts as they are in that case and not on the basis of what the Court said.

I just read you that the Court said, "We reaffirm that stabilization is illegal, per se," and you have the audacity to sit there and say it does not mean that. Who are you?

Mr. BAXTER. I did not say it did not mean that. That is what the opinion means, but that does not make it the holding of the Court.

Senator METZENBAUM. I told you once before, Mr. Baxter, that I believed you belonged back in the world of academia, and I still believe that. I just think that of all the people I have ever had appear before a committee, I have never had anyone come before me and say the law is not the law; that the words and commas and paragraphs of the Supreme Court do not mean what they say.

I have never heard any other witness or any official of government make those kinds of statements, and where you come from I do not have the slightest idea.

Mr. BAXTER. Well, where I come from, we make fairly refined distinctions between different words, and what the law is is a very different question from what the holding in a particular case is. That, in turn, is a different question from what the opinion said, and those are words to which most lawyers I know attach rather specific and well-defined meanings. That is what I am doing, and I do not accept your characterization of that process.

Senator METZENBAUM. Mr. Baxter, one of the market definition processes in the guidelines asks which companies could and would shift resources to begin production of a different product if prices in the challenged industry went up 5 percent for 6 months.

This is the same question I asked Mr. Miller. How can that theoretical prediction be made in real life? It is probably a more appropriate question for you because it is part of the Antitrust Division's guidelines.

Mr. BAXTER. Certainly, it is an appropriate question. The question is an illustrative question of the sentence that immediately precedes it in the guidelines. As the sentence that immediately precedes indicates, the critical question is whether prevailing patterns of substitution, either with respect to product type or with respect to geographic shipment, would change in the face of a small but nontrivial and enduring change in price.

In an effort to convey to people the range of size of price change that we had in mind, we went on to say—I am paraphrasing; I do not have the language immediately in front of me—as a first approximation, we will hypothesize a 5-percent price increase. There is nothing magic about 5 percent, but we were anxious to convey to readers that we did not have in mind 25 percent or one-quarter of 1 percent. So, the 5-percent figure was intended to suggest the general range of magnitude of the price increase which we had in mind.

Now, how would one know how shipment patterns might change? Sometimes, you will have almost no information on that; one will have to make a fairly intuitive guess. In other circumstances, there will be a great deal of information available.

There may have been historic situations where relative prices between two areas changed before and one was able actually to go to transportation records and observe shipment levels that responded to such a change.

So, the answer is sometimes one will have very good evidence of what the answer is; sometimes, one will have almost no evidence at

all and will be forced to make a quite intuitive guess. Intuitive guesses, of course, are not entirely satisfactory, but I would rather have a sensible intuitive guess about the answer to the right question than to have an enormously precise answer to the wrong question. And that is the right question.

Senator METZENBAUM. Even assuming that these predictions could somehow be made, I question the extent to which you appear to be willing to rely on these factors in looking at mergers. For example, if oil purchasers could switch to natural gas or some other fuel, why should we allow the waste of billions of dollars of scarce capital that produces no benefits but increases the concentration of power in the hands of a few big oil companies?

Mr. BAXTER. Well, I am not sure I really followed that observation or question.

Senator METZENBAUM. Well, let me put it this way.

Mr. BAXTER. Yes.

Senator METZENBAUM. In connection with Gulf-Cities Service, Cities Service, it is my understanding, has tremendous natural gas resources, and Cities Service, left to its own designs, could very well push up its production of natural gas. That could then provide a competitive supply factor as against oil, and it seems to me that there is a reality there that you should be taking that into consideration.

If Gulf acquires Cities Service, then that competitive aspect could very well be eliminated, or at least deterred. So, it seems to me that this question of the 5 percent and if you shift resources to begin production of a different product—if prices in the challenged industry would go up 5 percent for 6 months, it seems that you do have oil and natural gas involvement.

Perhaps it is not an answerable question. Perhaps I am not making myself clear, and if I am not then I will withdraw the question.

Mr. BAXTER. Well, I think I understand your more recent comments somewhat better. You appear to be raising the question of whether natural gas and petroleum are really in the same product market. While I would like to take a look at some data before I gave a definitive answer my intuitive response is the following: Although natural gas and petroleum are very close substitutes in a fraction of their uses and an increase of 5 percent in the price of one or the other would lead to some substitution in those particular uses, the substitution at any price change of the general order of 5 percent would be very, very limited and confined to a very narrow subset of those possible uses.

So, I would be inclined intuitively to regard the two as in different markets. Now, in the face of a much greater price change over a much longer period of time, of course, the degree of substitution would be a great deal greater, and that is why it is not enough to ask if prices went up, would there be substitution. One has to talk about the magnitude of the price change and the duration, or at least the expected duration, of the price change, as the guidelines do.

Senator METZENBAUM. Do you feel that the guidelines provide sufficient specificity to make it possible for lawyers generally to be able to advise their clients of what will or will not be approved?

Mr. BAXTER. I think so, Senator. I will make an oversimplified division of the antitrust bar into two segments and refer to what is obviously a spectrum as if it were two segments.

I think the antitrust bar that has done a fair amount of merger work indeed has followed antitrust quite closely in recent years. They have already learned quite a bit of economics. It is no surprise that the two subjects are very closely related. I have many, many friends in that category in cities all over the United States, and indeed all over the world, and for them the guidelines really say nothing new. They articulate in perhaps slightly different ways what they have known all along and what they have always done. Indeed, if one talks to industrial organization economists about the guidelines, one gets that reaction to an even greater extent.

Antitrust lawyers who are less deeply immersed in the field—perhaps just the business lawyer who comes to a substantial merger for the first time—would find the guidelines difficult reading, fairly complex. He probably would need some help. He might want to engage an economist to assist him in his preparation. That is regrettable.

I wish we could have made them simpler. We tried to make them just as simple as we conceivably could. There is an inescapable tension, of course, between simplicity and really reaching those particular mergers which are going to be anti-competitive.

I do not mean to be facetious, but to make my point I would say the simplest set of rules you could possibly have would be that we will approve mergers that are executed on Monday, Wednesday, and Friday and disapprove those on Tuesday and Thursday. No one would have any question as to the exact implications of that, and yet obviously they would be quite unsatisfactory as guidelines.

So, one struggles as best one can with this difficulty. The topic is not a simple one. Our knowledge about the circumstances under which mergers are likely to have anti-competitive effects is imperfect. We deal with probabilities, not with certainties. There is no magic formula that enables us to attach weight to the various circumstances that should be taken into account.

The general consensus is that concentration is probably the most important single factor, and that shows up, of course, in the guidelines. But there is just no complete resolution of the fact that the more you try to take advantage of all we know as a scientific matter about this problem, the murkier and more uncertain the articulation effort becomes.

We struck a particular balance in that tension; it was the best we were able to do. I am quite satisfied with it, but we did not overcome it completely. I quite agree with your comment that some people will find the guidelines difficult reading and somewhat confusing.

Senator METZENBAUM. Well, the guidelines suggest that mergers will be treated more tolerantly where it is easy for new firms to enter the market. Once again, you have to rely on predictions that are based on hypothetical price increases over time.

What if your predictions are wrong? Does not this reliance on theory mean that you can justify all mergers by fitting them within your theoretical ideas of ease of market entry?

Mr. BAXTER. No, no, certainly not. Entry into most industries where the construction of new facilities is required is a 4- to 12-year process. The entry that we refer to in the guidelines is much shorter.

The effort there is simply to avoid the opposite kind of mistake. Sometimes, it is possible to look at what one supposes is an industry and find that one or some small number of firms have a very large share of that industry. Yet, as soon as one asks the question, what would happen if prices went up a little bit, it becomes apparent that a different set of firms in technologically related industries would be able to move into the industry very quickly.

Of course, the consequence of this relatively easy entry is that the tentatively defined industry which you defined the first time around is not one where price could profitably be increased. The implications of that are two: First, that the merger will not, in fact, be anticompetitive; and, second, if the merger does involve efficiencies, as many mergers do, you would simply be making a mistake of a different kind. You would be blocking the attainment of efficiencies without any tradeoff in terms of protecting against anticompetitive consequences. That would be as bad for consumers as the error of failing to block a merger that was anticompetitive.

So, the effort again is one to achieve balance between the desirable properties of mergers and their possible anticompetitive effects. We believe that the desirable properties are present in many, if not most, mergers but we never know for sure whether they are present in particular cases, just as we never know for certain whether a particular merger will be anticompetitive.

So, the guidelines represent an attempt to strike an optimum tradeoff between efficiency considerations on the one hand and anticompetitive considerations on the other.

Senator METZENBAUM. Mr. Baxter, I am in an embarrassing position. I agreed to remain until 11:30, and I am going to have to leave. We did hear from Senator Thurmond that he is going to be delayed. I hope that, pursuant to the suggestion of Senator Thurmond, you will be good enough to respond to questions from his staff, and I apologize for not being able to remain myself.

Mr. BAXTER. Thank you, Senator. I would be happy to respond to the staff's questions.

Ms. TIFFANY. Mr. Baxter, in the 1968 guidelines a line of commerce for purposes of defining a relevant market included only products or services distinguishable as a matter of commercial practice from other products or services, even though from the standpoint of most purchasers other products may be reasonably but not perfectly interchangeable with it in terms of price quality and use.

The policy reason given for this was, "the Department seeks primarily to prevent mergers which change market structure in a direction likely to create a power to behave noncompetitively in the production and sale of any particular product, even though that power will ultimately be limited, though not nullified, by the presence of other similar products that, while reasonably interchangeable, are less than perfect substitutes."

Under the new guidelines, if a product is reasonably substitutable, it will be included in the product market definition. Does this

reflect a change in the Department of Justice policy from that stated in the 1968 guidelines?

Mr. BAXTER. I think it does, although it is difficult to say with certainty. The earlier language is vague in some senses, as is our later language. Now, we attempted to clarify our later language by the examples we used, including, again, the hypothesized 5-percent price change, in an attempt to suggest just how much substitutability we thought was reasonable substitutability.

There were no such aids in the 1968 guidelines, so that I can read the 1968 guidelines and say they could mean exactly the same things that ours meant. But as I hear the words, they sound to me to be talking about narrower product markets than we are talking about. So, my hunch is that the answer is, yes, I think it does represent a policy change toward more broadly defined markets, but that is not inescapable on the face of the language.

Ms. TIFFANY. With respect to a geographic market, the 1968 guidelines basically included only firms making substantial sales to purchasers in a given section of the country. The policy given for this approach was the Department's belief that it is, "most consistent with the purposes of section VII to challenge any merger which appears to be illegal in any reasonable geographic market, even though in another reasonable market, it would not appear to be illegal."

Again, are the standards of the 1968 guidelines intended to reflect a change of this policy?

Mr. BAXTER. I think it is somewhat clearer in the case of geographic definition that the current guidelines do make reference to broader markets than the 1968 guidelines did. The 1968 guidelines seem quite studiously to say that one can only look at existing shipment patterns. They neglect to ask about the extent to which, in the face of an even trivially small change in price, shipments from elsewhere might flow in. That, from an economic standpoint, of course, makes no sense whatsoever, but I do think that is the way the 1968 guidelines read.

Ms. TIFFANY. Given that these were the policies, and now they are apparently being modified, is that modification based on changes or advances in economic analysis or legal analysis, or both, and could you be a little more specific on the reasons?

Mr. BAXTER. I suspect it is based on a combination of the two, really. Surely, it was no secret to economists in 1968 that a merger between two firms who were present shippers of a product to a given territory could not possibly have anticompetitive effects if even a slight price increase would be met by a deluge of shipments from surrounding areas. In that sense, the 1968 guidelines did not even reflect the well-established learning of the times.

Undoubtedly, they reflected the far more extreme hostility to mergers that was reflected in the judicial opinions of the era, as well as a necessarily somewhat earlier view, and therefore inescapably less complete view, than we have today of the causes of anticompetitive behavior.

So, there is not any question that the tone as well as the actual substantive content of the new guidelines differs from those in 1968. That is why it was not only appropriate but important that there be new guidelines, and I think they do reflect both a richer

understanding of the underlying economic problems and also a change in legal and judicial attitudes concerning the utility of more rather than less Government intervention and concerning the extent to which markets, in general, behave effectively and desirably to achieve efficient resource allocation.

Ms. TIFFANY. To what extent do these differences between the 1968 guidelines and the new guidelines reflect changes that have already occurred in Justice Department policy over the years, as opposed to changes that are being initiated with the new guidelines?

Mr. BAXTER. Well, certainly, to a substantial extent they merely ratify changes that have already occurred in enforcement policy. Indeed, if one looks at enforcement policy during the last year and a half while I have been there, I guess I would say they do no more than reflect the change in enforcement policy. That, in a sense, of course, is cheating; that is merely to say that both reflect the views with which I came to my present position.

But even if one were to compare the guidelines with the enforcement attitudes of the year immediately preceding my arrival, I think one would say that a very large portion of the differences between the new guidelines and the old guidelines had occurred in practice by that 1980 date. I am reluctant to try to tell you that it is 60 percent ratification and 40 percent new or some such number as that. I think that would be arbitrary and foolish to undertake.

But, certainly, the enforcement practice had moved a long way from the 1968 guidelines in the direction of the new guidelines before I got here.

Ms. TIFFANY. In a recent article published in the Harvard Law Review entitled "The Accuracy of Traditional Market Power Analysis and a Direct Adjustment Alternative," Louis Kaplow criticizes the inclusion of substitutable goods in the market definition.

He asserts that once imperfect substitutes are considered close enough to include in the market, they are then treated for purposes of calculating market share as though they were perfect substitutes. This, he claims, leads to an understatement of market power. How would you respond to this criticism?

Mr. BAXTER. I think, in theory, that is correct. Ideally, one would, I suppose, try to have some sliding scale and one would adjust the extent to which a product is included in the market by its degree of substitutability with other products in the market.

I do not think that kind of sliding scale continuum approach is a feasible one, and I think one is forced into the position—unless one is going to try to develop very complex, continuous solution to these problems—of counting as 100 percent in the market those products or suppliers who are very close and not counting in at all other products and suppliers that do have some substitutable qualities.

Maybe—if there were a very large company or it was terribly critical as to whether you put the product in or out and the product was in the middle of the substitutability range—at that point you might want to say, "Well, we will put it half in," which is what I gather that that article is saying, although I have not read the article yet. It is a process that might be worth considering.

On the other hand, to suggest that, unless it is perfectly substitutable, it be kept out 100 percent, seems to me just as mistaken as to say if it is substitutable at all, you put it in 100 percent.

Ms. TIFFANY. Actually, the alternative that Kaplow suggests in the article is direct adjustment of market power by the degree to which the mitigating factors, such as substitutability of other products, deviates from their ordinary level. He basically argues that substitutability is, in fact, assumed when you are looking at market shares because if there were absolutely no substitutability, even very small market shares would be much more significant than they are considered to be.

So, in evaluating where to place the thresholds, there is an assumption of a normal degree of substitutability. He is advocating emphasizing or deemphasizing the significance of market share according to what exists in the market.

Mr. BAXTER. Well, I have no quarrel, in theory, with that. I guess my response to that is that what we really are talking about is the elasticity of demand confronted by a single firm or group of firms and the elasticity of supply and cross-elasticities of supply and demand. And since those numbers will rarely, if ever, be available to us—or, more accurately, the specification of their equations will rarely, if ever, be available to us—we try to approximate them as lawyers by using proxies for them of various kinds.

All proxies are defective in some degree, and he is suggesting a slightly different set of proxies, but there is no underlying conflict at all. It is, after all, an empirical question as to whether one proxy is better than another, and that data itself is very difficult to come by.

Ms. TIFFANY. I guess another criteria would be which approach would give more predictability to people in the industry, and I do not think it is clear from the face which one would.

Mr. BAXTER. I do not think it is clear either.

Ms. TIFFANY. Another of Professor Kaplow's criticisms is that users of the market redefinition approach, which is essentially defining the market rather than using his direct adjustment alternative, may err by emphasizing substitution possibilities by reference to prevailing market conditions. This approach, he argues, fails to recognize that prices may already reflect significant market power, causing poor substitutes to be accepted by some segments of the market.

Thus, substitutability may be overstated if current substitution patterns are considered, which in turn will tend to understate market power. How would you respond to this concern?

Mr. BAXTER. Well, again, there is no question that if prices are presently above competitive levels, imperfect substitutes will already have been drawn into the market by those high prices, and there will be the appearance of more competition and less market power than there really is.

That is a serious problem in Sherman Act section II litigation, where, by hypothesis, the Government's position or the plaintiff's position is that some company has an undue degree of market power, presumably setting price too high. Therefore, presumably, too many imperfect substitutes will be apparently in the market.

In the merger context, however, the question we are asking is a different question. Will this merger make things worse? Will it impair competitive performance? The mere fact that a market is behaving noncompetitively at the present time is no particular reason to halt a merger if the merger is not going to make performance either better or worse.

So, in the merger context, we are always asking the question, is the merger likely to render competitive performance less satisfactory?

Now, since that is the nature of the inquiry, the risk is precisely the opposite one from the risk suggested in the article from which you are reading. The risk is not that the appearance of market power will be too low because too many products have been drawn into the market. It is that the appearance of market power will be too great because it ignores the fact that additional products would be drawn into the market if the price were to go up.

So, in this sense one encounters one risk of analysis in merger cases and the other risk of analysis in section II cases, and the author of that article is talking about the risk that appears in section II cases, although I gather he is talking about it in the context of an article dealing with mergers.

Ms. TIFFANY. I think the point that he is trying to make is that in looking at the market and trying to decide which products are reasonably substitutable, one of the things you look at is which products are being substituted. By looking at the actual substituted products, you are going to get a distorted perception of what are, in fact, reasonably substitutable products because less desirable substitutes have already come into the market due to market power that is being exercised.

Mr. BAXTER. Due to market power that is being exercised.

Ms. TIFFANY. Yes.

Mr. BAXTER. That is quite right, but even if we were sure that we were confronting that kind of a situation and we were examining a proposed merger in such an industry, I would take the position that the right question still was: Will the merger make things worse? The only way to find out whether the merger will make things worse is to hypothesize still a further price increase and ask what would be brought in, and I would take the existing situation as given.

Now, of course, if someone suggests that I bring a section II case to prevent the exercise of the market power which we hypothesize is present, I would say that the article makes a very sensible suggestion, depending on the circumstances. Then you would face the opposite kind of analytical error risk. But I do not agree with him that that is a risk that one encounters in merger analysis as opposed to section II analysis.

Ms. TIFFANY. In another recent Harvard Law Review article entitled, "Herfindahl: Concentration, Rivalry, and Mergers," the authors argue that an important factor in computing market power is the nature of interfirm rivalry in the market. Specifically, they refer to a firm's perception of interaction with other large firms in the market.

Do your guidelines allow for taking into consideration these kinds of perceptions?

Mr. BAXTER. Well, your description of their position is quite a general one, but if I interpret it correctly, my answer would be yes. Firms selling homogeneous products in standard size containers will have a very different perception of the directness of competition between themselves and a heightened sense of interdependence in comparison with firms selling far more heterogeneous products, for example, and that is one of our factors.

I do not mean to bore you with it now, but if I were to run through our list of other factors, so-called, that appears in section III(c) of the guidelines, I would take the position that in each case those other factors were responsive to the considerations that seem to me to be suggested by the phrase you have read from that law review article.

Ms. TIFFANY. In his book "Antitrust Law," Robert Posner criticizes the concept of market power by stating that, "It is unlikely that a firm lacking a monopoly market share could unilaterally keep its price substantially above the competitive level. The real significance of concentration, which is obscured by the term 'market power,' is that it facilitates collusion, explicit or tacit, among the firms in the market by reducing the costs of collusion and detecting cheating."

Does the emphasis of the guidelines on market power indicate that you disagree with Professor Posner on this point?

Mr. BAXTER. No, no; quite the contrary. I entirely agree with Professor Posner on that point—well, I am not sure I entirely agree. I do not have any difficulty imagining circumstances where a single firm would have a sufficiently large market share and the difficulties of entry would be sufficiently great so that it could maintain price above competitive levels for a very substantial period of time.

Now, to be sure, it would lose market share at an accelerated rate if it did so and would eventually have to reduce its price to competitive levels, but that might be over a period of some years.

Of course, in the guidelines we have a small section on the dominant firm which has more than 35 percent of the market, and so on. So, we acknowledge the existence of that problem, but I entirely agree with Professor Posner that it is the rarity; that the overwhelming preponderance of cases pose problems about collusion, and indeed the central and orienting theme of the merger guidelines is, quite consistent with his suggestion, to make sure that the costs of collusion do not get too low and that high concentration is significant predominantly because it reflects low costs of collusion.

Ms. TIFFANY. How did you come to select 1,000 and 1,800 as thresholds for antitrust review?

Mr. BAXTER. Well, that is not a very easy question. If we had all been born with four fingers and four toes, I suspect some different number would have been selected. Other than thus noting that they are round numbers, I would say they are at the levels that, on several different grounds, seemed about right.

The only reason those particular numbers were selected is, no doubt, because they were round numbers in the right range. Why do I say the right range? Well, that goes back again, really, to your last question. What do we know about the potential for and the difficulties of collusion in markets with different numbers of players?

One way to think about those numbers is simply to divide them into 10,000. If you divide any of these numbers into 10,000, the result is the number of equal-size firms that characterize such a market. So, in an industry that has a Herfindahl index of 1,000, if the firms are of equal size, there are 10 such firms. Ten such firms is a fairly large number of firms in order to collude effectively.

The costs of collusion are generally assumed to be an exponential function of the number of people colluding, and with 10, those costs would be very high. If one divides 1,800 into 10,000, one gets 5 and a fraction equal-size firms. Now, you are getting down to an area where collusion is a much more realistic possibility, and that is one answer to your question.

That, as a matter of intuitive feel, seemed about right for a level below which you could just forget about serious concern—the 1,000 level—a level where one really had to be very chary about a further reduction in the number of firms, because collusion was becoming quite feasible.

We also did some empirical studies on four-firm concentration ratios and two-firm concentration ratios that corresponded to different Herfindahl index numbers, using industrial market data. It turns out that a 1,000 Herfindahl index corresponds to about a 50-percent four-firm concentration ratio, and an 1,800 corresponds to about a 70-percent four-firm concentration ratio.

That gives the two index numbers we selected a pretty good fit with the empirical literature on profitability, which tends to show breaks in the profit functions in those ranges. Most of that empirical work was done with reference to four-firm concentration ratios rather than the Herfindahl Index, and so it was necessary to connect the former to the latter in order to make that check.

So that, too, supported our selection of those two numbers, but it certainly did not dictate it. If someone were to come along and insist that 900 or 1,100 would have been a superior choice to 1,000 and 1,700 or 1,900 a superior choice to 1,800, I would be entitled to say, "What makes you think so," but I could not prove he was wrong.

Ms. TIFFANY. You have mentioned collusion as being a major concern underlying the guidelines, and also as an important factor in setting the HHI index levels. There are a number of other factors which have been expressed as being important in determining antitrust policy—factors such as wealth transfer concerns, concerns about size per se, deterrents, and the effect a merger might have on future similar mergers.

How much weight do you think may appropriately be given to these other factors.

Mr. BAXTER. Well, in the present state of the statutory law, which says that a merger is unlawful if it may substantially lessen competition in any line of commerce in any section of the country, it seems to me difficult to give any weight to those factors.

On the other hand, some of them are very closely correlated with the factors we have already talked about. The first you referred to, if I recall, was income distribution. One would not need to depart in any significant way from a purely efficiency-oriented body of antitrust to maximize the antitrust impact on wealth distribution, as it is usually used. When people talk about wealth distribution,

they usually implicitly have in mind that a more egalitarian wealth distribution is a desirable thing.

If that is one's presupposition in that area, then an efficiency-oriented body of antitrust law is quite congruent with it. That follows from the fact that, on average, consumers will be in lower portions of the income distribution than producers. Now, of course, that is not uniformly true. One of the oddities of a strong attachment to egalitarian income distribution would arise if one were talking about a conspiracy between manufacturers of yachts, for example, where one might find that the average consumer is in a rather higher portion of the income distribution; or perhaps even very high-priced imported sports automobiles.

But I do not know whether the people who think that is an important consideration would really suggest that one should tolerate a conspiracy among yacht manufacturers for those purposes or not.

So, one would have to take these other factors on a one-by-one basis and really hold them up and ask exactly what their implications would be in each of a wide variety of cases. I have done that, and my own conclusion is that it is almost impossible to work with some of the factors and that others are entirely congruous with what we are now doing. Nothing would be added except complexity to pretend that we were simultaneously and independently taking those into account.

Ms. TIFFANY. The guidelines anticipate a very thorough and complex analysis of market conditions in determining market power. Is the Department likely to have either the time or the necessary information about such matters as shipping patterns of competitors to perform this ambitious analysis?

Mr. BAXTER. In many Hart-Scott-Rodino contexts, we will not have. We, of course, can ask for additional information and extend the time constraints to which we are subject by doing so. Nevertheless, the information simply will not be fully available in many Hart-Scott-Rodino contexts. That is too bad.

I would not suggest lengthening the Hart-Scott-Rodino waiting periods for that reason. My judgment is that in substantially all cases we will be able to get enough information together to make highly educated and fairly reliable predictions about what the answers would turn out to be if we had 2 years to study them, and I think that is about as good as one can hope to do.

In the occasional case where that is not true, there is nothing that says we have to bring suit within the Hart-Scott-Rodino period. We can always let the merger go forward, with a warning that we are not through studying it yet. We can indicate that, although we do not seek to enjoin it at this particular point in time, if they choose to go forward they should be aware that when we get through studying it we may be back with a Clayton Act, section 7, complaint. So, we can take the additional time if we really need it.

My experience so far has been that it is a very unusual circumstance when we cannot get a quite good fix within the Hart-Scott-Rodino period, even though there is always more that we would like to know.

Ms. TIFFANY. Thank you very much, Mr. Baxter. I know that Senator Specter has some questions that he will want to submit to you in writing, and I am certain that Senator Thurmond will have

some other questions he will want to send to you as well. So, if it will be all right, we will be sending some questions to you.

Mr. BAXTER. Surely. I will deal with them when they come.

Ms. TIFFANY. This hearing is now concluded. Thank you very much.

Mr. BAXTER. Thank you.

[Whereupon, at 12:06 p.m., the committee was adjourned.]

[The following was subsequently supplied for the record:]

U.S. Department of Justice

Antitrust Division

Office of the Assistant Attorney General *Washington, D.C. 20530*

NOV 19 1982

Honorable Strom Thurmond
Chairman
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

It is my pleasure to submit for the record the following answers to the questions that you sent to me on July 30, 1982, in follow-up to my July 21, 1982, testimony before the Committee on the Judiciary concerning the new Department of Justice Merger Guidelines.

1. Do you see any differences in the Department's current expression of the failing company doctrine from that expressed in the 1968 guidelines?

Answer: This is one area in which no substantive change was intended. The new Merger Guidelines offer a more precise definition of what "failing" means than did the 1968 Guidelines, but otherwise the two statements are essentially identical.

2. What major differences do you see between the 1968 and the current guidelines with respect to vertical mergers?

Answer: Both sets of Guidelines indicate that vertical mergers may be challenged where they make entry into a market significantly more difficult. The two differ very significantly, however, in their identification of the circumstances under which this might occur. In addition, the new Guidelines, unlike the 1968 set, recognize that vertical mergers could sometimes facilitate collusion among competitors or enable a regulated monopolist to earn supracompetitive profits by evading regulation.

The drafters of the 1968 Guidelines presumed that entry barriers would be significantly increased by almost any substantial vertical merger, and therefore set rather arbitrary (and low) market share tests for determining which vertical

mergers would be challenged. In practice, however, this soon ceased to be the Department's policy because it was recognized that vertical mergers, in fact, generally are not anticompetitive.

The new Merger Guidelines reflect this improved understanding of the competitive effect of vertical mergers, and, accordingly, they focus directly on the conditions under which vertical mergers may increase entry barriers. Specifically, our new Guidelines note that entry barriers can be raised by vertical mergers if, after a merger, it would be necessary for a new entrant to enter at two levels whereas before the merger entry at one level would have been sufficient. We further note, however, that barriers to entry are unlikely to affect performance if the structure of the market is otherwise not conducive to monopolization or collusion. Therefore, the Department is unlikely to challenge a vertical merger on account of any increase in entry barriers unless the market is rather highly concentrated.

3. What major differences do you see between the 1968 and the current guidelines with respect to conglomerate mergers?

Answer: The 1968 Guidelines identified three categories of conglomerate mergers that might be challenged: mergers involving potential entrants, mergers "creating danger of reciprocal buying," and mergers "which entrench market power." The Department's policy with respect to mergers that eliminate potential entrants has not changed significantly, although the new Merger Guidelines contain somewhat different specific enforcement standards for such mergers. The other two rationales for challenging conglomerate mergers were advocated successfully by the Federal Trade Commission in the mid-1960s, which accounts for their appearance in the 1968 Guidelines. However, I know of no case that the Department has successfully brought under either theory. More importantly, neither theory is economically sensible. Accordingly, the new Merger Guidelines do not mention either of these two theories.

Questions Submitted by Senator Specter

1. We are very much concerned that the new guidelines do not provide much in the way of practical advice to the business community as to what mergers might be challenged. For example, if the acquisition of Consolidated Steel Corporation by United States Steel Corporation were to be proposed today, would it be challenged by the Department under the new guidelines?

If yes, would you please explain how the executives and legal counsel for the respective companies could have anticipated the challenge by using the guidelines.

If no, would you please explain why there would not be a challenge and how that decision comports with the 1950 Amendment to Section 7 of the Clayton Act which was in part a response to the Supreme Court's decision in United States v. Columbia Steel, 334 U.S. 495 (1948), and which was intended, "to cope with monopolistic tendencies in their incipiency and well before they have attained such effect as would justify a Sherman Act proceeding." S. Rep. No. 1775, 81st Cong. 2d Sess.

Answer: Some early commentators on the new Guidelines suggested that they were too complex to provide an adequate basis for businessmen and their advisors to anticipate our enforcement intentions. This type of criticism was to be expected because the Guidelines incorporated new approaches to such complicated problems as market definition and measurement. With time, however, this criticism has abated, as we expected it would, because the Guidelines' apparent complexity has faded with their increased familiarity.

To be sure, the Guidelines will not give a definite answer with respect to every conceivable merger, but any merger policy based upon competitive effects must necessarily involve some uncertainty. Formulation of a general statement of merger enforcement policy inevitably involves a trade-off between simplicity and correctness, for analysis of the likely competitive effect of any particular proposed merger is ultimately a very fact-specific process. Market definition, for example, is simply too subtle a process to be reduced to mechanical rules. We tried, however, to make the Guidelines as specific as possible, and I believe that we produced a reasonably clear guide to our enforcement intentions in a very complex area of the law.

Turning to the 1947 acquisition of Consolidated Steel Corporation by United States Steel Corporation, it would not be possible to give a definitive analysis of that transaction under our new Guidelines without more information than is contained in the Supreme Court's opinion. There is nothing in that opinion, however, which indicates that the Department would challenge the acquisition under the new Guidelines.

The case was brought under both vertical and horizontal theories. As I indicated earlier, the Department will challenge vertical mergers where it is likely that entry barriers will

be increased substantially, but this danger does not seem to have been present in Columbia Steel. U.S. Steel was only one of several sources of supply to west coast steel fabricators, and its acquisition of Consolidated appears unlikely to have raised entry barriers because firms that desired to enter steel fabrication apparently still would not have needed to enter raw steel production also.

With respect to the horizontal aspect of the transaction, the Government's allegations indicate that the Herfindahl-Hirschman Index of market concentration was about 540 before the merger and about 850 after it. This latter figure is sufficiently below 1000 to make it highly unlikely that the acquisition would have been challenged today. However, it appears that the product market alleged by the Government in Columbia Steel may have been inappropriate, resulting in a substantial overstatement of the degree of competition between the two firms. The Court cited evidence indicating that U.S. Steel and Consolidated Steel actually produced quite different products, and it found very little competition between the two. Under the market definition principles of the new Merger Guidelines, therefore, the two firms might have been considered to be in different product markets. Thus, there is nothing in the Supreme Court's opinion to indicate that the acquisition would have been challenged under our new Guidelines.

This result would not, in any way, conflict with the purpose of the Celler-Kefauver Act of 1950. As as we stated in our Guidelines, they "reflect congressional intent that merger enforcement should interdict competitive problems in their incipiency." Based on the facts presented in the Court's Columbia Steel decision, however, the transaction challenged there simply did not involve "monopolistic tendencies"--"in their incipiency" or otherwise.

2. In Section IIA of the guidelines, you refer to narrower product markets that may be defined in cases where there is a possibility of price discrimination. Would you please describe the nature of these narrower markets and explain how such markets would be defined?

Answer: All markets will be defined in the same way. The Department will examine the products and locations of the merging firms and consider a series of possible markets of increasing size in both product and the geographic dimensions. A group of products and an area will be considered to be a market only if "a hypothetical, unregulated firm that made all the sales of those products in that area could increase its profits through a small but significant and non-transitory increase in price."

Absent the ability to engage in price discrimination, the Department would postulate a uniform increase in factory-gate prices to all customers, and ask whether this increase would be profitable. A uniform increase in price by sellers in a small area often would not be profitable because it would cause the loss of many relatively distant customers who could easily substitute products produced outside the area in question. If, however, geographic discrimination were possible, the Department would also postulate a price increase only to the local customers who might not be in position to substitute. Such a price increase would not cause the loss of distant customers because they would not be subject to it. Thus, this discriminatory price increase could be profitable even if a nondiscriminatory price increase would not be. The evidence and analysis that would be used to judge the profit effects of the two types of price increases would be essentially the same.

3. In "A Walk Through the Merger Guidelines," Jeffrey Zuckerman, Special Assistant to Mr. Baxter, refers to the one-year/5% test as a measurement "standard". What do you mean by "standard"? Although 1 year/5% may be apposite in the majority of industries, should industries which are more price sensitive or insensitive than the average, be held to different standards?

Answer: As stated in response to Question 2 above, the Department considers a product and an area to be a market for purposes of merger analysis if "a hypothetical, unregulated firm that made all the sales of that product in that area could increase its profits through a small but significant and non-transitory increase in price." The exact meaning of the underscored phrase is critical to conclusions reached under this test. Elaborating on that phrase, the new Merger Guidelines also state that "[a]s a first approximation, the Department will hypothesize a price increase of five percent and ask how many buyers would be likely to substitute . . . within one year."

The term "first approximation" was meant to connote that the use of five percent and one year was something more than a mere example and something less than a hard-and-fast rule. Mr. Zuckerman's speech made exactly this point by stating that five percent and one year were used "to give an idea of what [the Department] mean[s]" by a "small but significant and non-transitory increase in price." The Guidelines note that "a given percentage price increase may be more significant in some industries than others," and the Department may use somewhat different price and time thresholds where appropriate in particular cases.

4. Why have you shifted away from the 1968 emphasis on demand-defined markets to the 1982 emphasis on supply-defined markets? Won't this tend to broaden market definition and, hence, lead to less enforcement?

Answer: The 1968 Guidelines defined a market as a group of products and area "in which each of the firms whose sales are included enjoys some advantage in competing with those firms whose sales are not included," and go on to state that the "advantage need not be great." Under the new Guidelines, the advantage must be great enough to make it profitable to impose a "small but significant and non-transitory increase in price." While the fact that a one percent price increase would be profitable might have been sufficient to satisfy the market definition standard of the 1968 Guidelines, it would not be sufficient today. I do not, however, predict any significant change in the number of lawsuits that will be filed because I do not believe that the 1968 Guidelines were ever interpreted literally on this point.

The 1968 Guidelines stated nothing about how substitution in production would be taken into account and they were soundly criticized for this omission. Actual practice in the Department had been to conclude that two products which could be interchangeably produced with the same facilities were necessarily in the same market. The new Merger Guidelines adopt a different approach, although the difference often will be reflected only in the terminology used, and the result will generally be the same. Two products will not be considered to be in the same market unless they are viewed by consumers as being good substitutes. If two products are not good substitutes in consumption, but are good substitutes in production, the Department will take that fact into account. This will not be done by lumping both in the same market; rather, producers of each product will be considered to be competitors in each of the two markets for the individual products. The resulting market share conclusions often will come out much as they did before, but this new approach should permit a more refined analysis in some cases.

5. The guidelines, with their economic theory orientation, seem to be concerned with price collusion as the only nocuous by-product of merger activity. Shouldn't DOJ enforcement policy also reflect concern with such matters as ensuring a business climate conducive to "mom and pop" enterprise, or discouraging foreign ownership of our critical industries?

Answer: Section 7 of the Clayton Act prohibits mergers the effect of which "may be substantially to lessen competition, or to tend to create a monopoly." The Department has formulated its enforcement policy in strict accordance with this statute. It would clearly be improper to enforce the law other than in accordance with its terms.

The antitrust laws are not the proper vehicle for achieving other social values, laudable though they may be. If Congress determines it desirable to continue to support a special category of firms, such as "mom and pop" enterprises, this should be done through some form of explicit, direct subsidy. This approach would preserve the consistency of the antitrust laws, and would reveal the economic costs of preserving the relevant social values, thus enabling better informed and more rational decisionmaking. Similarly, if Congress deems it necessary or appropriate to restrict foreign ownership of American firms, it should enact legislation to establish such restrictions.

6. At the New England Antitrust Conference on November 13, 1982, your assistant Tyler Baker, in previewing the new guidelines, indicated (a) that the Department was considering the creation of a presumptively illegal two-firm concentration ratio of 40% and (b) that the Herfindahl trigger point for "likely to be challenged" mergers would be 1600. The guidelines, as promulgated, do not have the 40% provision, and set the trigger point at 1800. Could you please explain why the Department has softened its position?

Answer: Mr. Baker's remarks came very early in the process of formulating the Guidelines. I ultimately decided that the use of the Herfindahl-Hirschman Index ("HHI") would be sufficient to deal with mergers that increase the likelihood of collusion among any number of large firms, including two. Thus, the "two-firm proviso" of which Mr. Baker had spoken became unnecessary.

However, the HHI standards do not address the problem of a single dominant firm that could raise price above competitive levels without the cooperation of competitors. To deal with this problem, we included a "leading-firm proviso," warning that the Department generally will challenge significant acquisitions by a firm which has a market share of at least thirty-five percent and whose share is at least twice that of the second-place firm.

With reference to our selection of 1800 as a threshold HHI, I cannot rigorously defend the choice, but neither could I do so for a choice of 1600 or 2000. As a practical matter,

the difference between 1600 and 1800 is rather slight, and of no real significance. The 1800 figure corresponds roughly to a four-firm concentration ratio of 65-75, which makes it consistent with the 1968 Guidelines' threshold for a highly concentrated market (a four-firm concentration ratio of 75). I ultimately selected 1800 over 1600 partly to avoid suggesting that the Department had lowered this threshold.

I hope that these responses will be useful to the Committee. Please let me know if I can be of any further assistance in this regard.

Sincerely yours,

William F. Baxter

William F. Baxter
Assistant Attorney General
Antitrust Division

○